

Defining Issues[®]

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Guidance on Section 404 Compliance

The SEC took a first step toward new guidance for management on complying with the assessment requirements on internal control over financial reporting, and COSO, known for its widely used evaluation framework on internal control, introduced its guidance to help smaller public companies with compliance.¹ COSO believes its new guidance can be helpful to companies of all sizes.

SEC Concept Release

A new SEC Concept Release requests comments on issues that might be the subject of guidance for management on assessing internal control over financial reporting.² The Release cites views and comments the SEC has received since it adopted rules implementing Section 404, including the views expressed at the Roundtable in May on second-year compliance experiences.³

The SEC continues to believe that methods to assess internal control over financial reporting will and should vary from company to company. It intends its planned guidance to be sensitive to the substantial resources many companies have already invested to establish and document programs and procedures to perform their assessments.

The SEC anticipates that its new guidance will be in the form of a rule that addresses three general topics:

- Risk and Control Identification – Identifying risks to the accuracy of financial-statement accounts and disclosures and the internal controls that address the risks, including how management might use company-level controls to address the risks.
- Management's Evaluation – The objectives of the evaluation procedures, the available methods or approaches to gather evidence to support management's assessment, and the factors management should consider to determine the nature, timing, and extent of its evaluation procedures.
- Supporting Documentation – Documentation requirements, the overall objectives of the documentation, and factors that might influence documentation requirements.

¹ COSO is the acronym for the Committee of Sponsoring Organizations of the Treadway Commission.

² SEC Release 34-54122, Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting, July 11, 2006, available at www.sec.gov.

³ Roundtable on Internal Control Reporting and Audit Provisions, May 10, 2006, conducted by the SEC and PCAOB.

The Release asks questions on many specific points related to the above topics. The questions also ask for comments on whether additional guidance would be useful for all issuers or just a subset of issuers, whether to incorporate the guidance the SEC staff published in May 2005, the particular subject areas that any additional guidance should address, and the extent of additional guidance that would be useful.⁴

The Release states that the SEC will continue to work with the PCAOB on revisions to its standard on auditing internal control over financial reporting and anticipates that any modifications to the guidance for auditors will be consistent with the SEC's guidance for management.⁵

Comments on the Release should be submitted to the SEC within 60 days after the date of publication in the Federal Register.

COSO Guidance for Smaller Public Companies

COSO began the release of its new guidance for smaller public companies on internal control over financial reporting by issuing the executive summary, one of a three-volume set on internal control over financial reporting in smaller companies, simultaneously publishing answers to 27 related frequently asked questions, and holding an interactive webcast on the guidance. Volume two on internal control over financial reporting in smaller business and volume three on tools to assist management in evaluating internal control are targeted for release a week from now.⁶

The new guidance is designed to help smaller public companies apply the *Internal Control – Integrated Framework*, issued by COSO in 1992. The Framework defines internal control as a process designed to provide reasonable assurance in achieving effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. Most companies have adopted the Framework as the basis for designing and assessing the effectiveness of their internal controls.

Board members can use the new guidance to discuss a company's internal control over financial reporting with senior management and to help the board monitor controls. Senior management and other personnel can use it to gain insights and ideas to increase the cost-effectiveness of the company's internal control structure. The guidance can also help management eliminate unnecessary or duplicate controls and unnecessary testing. Although the new guidance focuses on improving internal control over financial reporting, it may also be useful in evaluating the effectiveness and efficiency of operations and compliance with applicable laws and regulations.

Definition of "Smaller." COSO uses the term "smaller" public company and explains that there is no single definition of a small company. It then lists several characteristics of a "smaller" company:

- Fewer lines of business and product lines
- Concentrations of marketing focus, by channel or geography
- Leadership by management, with a wider span of control

- Less complex transaction processing systems and protocols
- Fewer personnel, many having a wider range of duties
- Limited ability to maintain deep resources in both line and support staff positions

The guidance points out that, despite the unique challenges smaller companies face in implementing and monitoring internal control, many of them have effective internal controls, although some may be less formally documented. Controls for smaller companies may include:

- Wide and direct control from the top, with senior management tending to be concentrated, allowing for more rapid identification of unexpected variances in financial reports. Smaller companies should be aware that concentrated authority presents the risk of management override and should implement controls to reduce it.
- An effective board of directors, facilitated by the tendency for smaller companies to have less complex business operations and structures.
- Compensating for limited segregation of duties by reviewing key supporting documents and overseeing key control procedures to verify that they are operating effectively.
- Information technology, for example, packaged or customized software with built-in application controls that can minimize information-technology risks.
- Monitoring activities, including those routinely performed in the day-to-day operation of the business.

⁴ Division of Corporation Finance and Office of Chief Accountant, *Staff Statement on Management's Report on Internal Control Over Financial Reporting*, May 16, 2005, available at www.sec.gov/info/accountants/stafficreporting.htm

⁵ PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, available at www.pcaobus.org.

⁶ Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control over Financial Reporting—Guidance for Smaller Public Companies*, Vol. 1, *Executive Summary*; Vol. 2, *Guidance*; Vol. 3, *Evaluation Tools*.



Management should ensure that company-level controls are operating at an appropriate level of precision. For example, annual budget-to-actual comparisons alone are probably not sufficiently precise to serve as an effective monitoring control.

Principles of Internal Control. COSO's guidance presents 20 principles that are associated with effective internal control over financial reporting. The principles are drawn from the five fundamental internal-control components of the Framework: the control environment, risk assessment, control activities, information and communication, and monitoring. Seventy-five related attributes support the 20 principles. The complexity of the company and its specific situation determines whether all 75 attributes are necessary.

Risk-Based, Integrated Controls. COSO's guidance holds that management should focus on those risks that are applicable to its organization and avoid using a generic list of controls for a "standard" or "typical" organization. However, companies should view the Framework's five fundamental internal-control components as an integrated process when assessing the effectiveness of internal control. Only when these five components are operating together to prevent or detect and correct material misstatements in the financial-reporting process can management obtain reasonable assurance that internal control is functioning effectively. A deficiency in any one of these components is a deficiency in the company's internal control.

Control Documentation. The COSO guidance underlines the importance of documenting controls, but emphasizes that the form and extent of the documentation should depend on the nature of the company's operations and regulatory requirements. No single level or form of documentation is necessary or appropriate for all entities. The COSO guidance explains that much of the documentation can be generated through the normal course of business.

Availability of the Guidance. The Executive Summary and Frequently Asked Questions are available now from the Web sites of each of COSO's sponsors:

- The American Institute of Certified Public Accountants, www.aicpa.org
- The American Accounting Association, www.aaa-edu.org
- Financial Executives International, www.fe.org
- The Institute of Internal Auditors, www.theiia.org
- The Institute of Management Accountants, www.imanet.org

Electronic and hard-copy versions of the entire three volume publication are expected to be available for purchase after July 18, 2006 at www.cpa2biz.com/stores/coso3.

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Contributing authors:

Walton T. Conn, Jr.
Melanie F. Dolan
Harold I. Zeidman
Allan J. Colaço
Ari A. Samuel

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