June 16, 2005

In Search of Internal Control - A Mid-Course Correction?

Two years after they were adopted, the SEC's rules under Section 404 of the Sarbanes-Oxley Act of 2002 have now been implemented by many large U.S. public companies.[1] These companies have included in their most recent annual reports a required statement by management assessing the effectiveness of internal control over financial reporting, and in some cases, have disclosed material weaknesses in internal control. Also, the independent auditors for such companies have completed the first audits of their clients' internal control over financial reporting under a new auditing standard promulgated by the Public Company Accounting Oversight Board, or the PCAOB.[2]

To say that the implementation of the rules under Section 404 has been challenging is an understatement, though not a surprise. For most public companies, these rules represent the single most significant requirement associated with the Sarbanes-Oxley Act. The costs of complying with the new rules have been substantial by any measure, as companies have upgraded IT systems, undertaken comprehensive reviews of their control systems, hired additional personnel and paid large fees to their auditors and other outside consultants and vendors.[3] These costs have been exacerbated by hesitancy on the part of auditors to exercise professional judgment in interpreting and applying the new rules and auditing standard, which caused companies to document and test a large number of controls during the first year of implementation.

Going back to when the SEC's rules were first proposed, and continuing throughout the implementation phase, both the SEC and the PCAOB have recognized that implementing Section 404 would present substantial challenges to public companies and auditors alike. Each has taken steps that reflect a sensitivity to such challenges, and both have recently issued statements further addressing a number of concerns raised in the initial implementation of the rules under Section 404.

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[1] The rules were reflected in amendments to Forms 10-Q and 10-K, Rules 13a-14, 13a-15, 15d-14 and 15d-15 under the Securities Exchange Act of 1934, and Item 307 of Regulation S-K, as well as new Item 308 of Regulation S-K and Exhibit 31 of Item 601 of Regulation S-K. *See* Rel. No. 33-8238 (Jun. 5, 2003) http://www.sec.gov/rules/final/33-8238.html.

[2] Auditing Standard No. 2 – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements ("Auditing Standard No. 2"). Auditing Standard No. 2 was included in Public Company Accounting Oversight Board Rel. No. 2004-001 (Mar. 9, 2004) http://www.pcaobus.org/Rules_of_the_Board/Documents/Release-20040308-1.pdf.

[3] One recent survey found that for 217 public companies with average revenues of $5 billion complying with the new rules under Section 404 during the first year cost an average of $4.36 million and that such companies devoted an average of 27,000 hours to their compliance efforts. *See* Financial Executives International, FEI Special Survey on SOX 404 Implementation (March 2005). The $4.36 million figure contrasts sharply with the SEC's estimate at the time the rules were adopted of $91,000 of annual costs per company (exclusive of the fees of the company's independent auditor).

The challenges of implementing the Section 404 rules, captured extensively in the legal, financial and accounting trade press, have also received attention from other policymakers. In a commencement address at the University of Pennsylvania's Wharton School of Business on May 15, 2005, Federal Reserve Chairman Alan Greenspan acknowledged the high costs of compliance but nevertheless endorsed the Sarbanes-Oxley Act with a somewhat backhanded compliment, expressing surprise that the act, "so rapidly developed and enacted, has functioned as well as it has." Some in Congress, on the other hand, view the costs of complying with Section 404 to be so excessive as to justify its repeal.[4] Although it is premature to conclude that the benefits to be derived from the new rules will ultimately outweigh the significant costs of compliance, most would agree that the search for a workable regulatory model for internal control over financial reporting is still underway.

The SEC's Rules

The SEC adopted rules implementing Section 404(a) of the Sarbanes-Oxley Act in May 2003 (see box).[5] On three separate occasions since then, the SEC extended the compliance dates for the rules, mainly in recognition of the challenges faced by registrants in complying with the rules' requirements and the substantial amount of work necessary to achieve compliance initially.[6] Currently, accelerated filers are required to comply with the rules beginning with their first annual report for the fiscal year ending on or after November 15, 2004, which means that most calendar-year accelerated filers have now filed their first reports under Section 404. Non-accelerated filers (including foreign private issuers) must comply with the rules beginning with their first annual report for the fiscal year ending on or after July 15, 2006.

The Internal Control Report

The SEC's rules under Section 404 require management to include a report on internal control over financial reporting in the company's annual report filed with the SEC. Management's report must contain the following:

- a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting;
- a statement identifying the framework used by management to evaluate the effectiveness of this internal control;
- management's year-end assessment of the effectiveness of this internal control and disclosure regarding any "material weaknesses" in such control; and
- a statement that the company's auditor has issued an attestation report on management's assessment.

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[4] In April 2005, Rep. Ron Paul (R-TX) introduced legislation to repeal Section 404.

[5] *See* Internal Control, Covington & Burling Client Advisory (Jun. 13, 2003).

[6] Under the rules as initially adopted, accelerated filers were required to comply beginning with the first fiscal year ending after June 15, 2004, and non-accelerated filers (including foreign private issuers) were required to comply beginning with the first fiscal year ending after April 15, 2005. In February 2004, the SEC extended the date for accelerated filers to November 15, 2004, and the date for other filers to July 15, 2005. In November 2004, the SEC issued an exemptive order to grant smaller accelerated filers (less than $700 million of public equity float) up to an additional 45 days to include the management's assessment required by Section 404 in their annual reports. In March 2005, the SEC extended the compliance date for non-accelerated filers (including foreign private issuers) to the first fiscal year ending on or after July 15, 2006.

Following adoption of the rules, numerous questions were raised regarding their implementation and interpretation. In response, the SEC issued a series of Frequently Asked Questions, or FAQs, regarding the rules.[7] These FAQs provide a number of helpful interpretations for registrants and auditors. For example, the FAQs confirm that auditors are only required to audit internal controls relating to the preparation of the registrant's GAAP financial statements, not its preparation of management's discussion and analysis of financial condition and results of operations. The FAQs provide registrants with flexibility in the context of an acquired entity, in that management is not required to assess the internal control over financial reporting for an acquired entity during the first year following its acquisition. The FAQs also address the form and content of management's assessment, stating that while the SEC's rules do not require the use of any specific language in the report, the staff expects management to use the term "material weakness" where management has identified any material weakness. In addition, the FAQs clarify that where the auditor's report on management's assessment of internal control is incorporated by reference into a Securities Act filing, a consent will be required with respect to both that report and the auditor's report on the financial statements.

In December 2004, the SEC announced the establishment of an Advisory Committee on Smaller Public Companies.[8] Although this advisory committee has a broad mandate to assess the impact of the current regulatory system for smaller companies under U.S securities laws, its charter and published agenda devote a substantial amount of attention to Section 404 and related issues.

PCAOB's Auditing Standard No. 2

In March 2004, as required by Section 404(b) of the Sarbanes-Oxley Act, the PCAOB adopted Auditing Standard No. 2, a new standard governing audits of internal control over financial reporting.[9] This standard calls for an integrated audit of a registrant's financial statements and its internal control over financial reporting and also requires the auditor separately to evaluate management's process for assessing the effectiveness of internal control over financial reporting. The new standard outlines a number of steps that the auditor must take to understand a company's internal control over financial reporting. These include identifying company-level controls, significant accounts and components of disclosure, relevant assertions where they have a meaningful bearing on whether a significant account is fairly stated, significant processes over each major class of transactions affecting significant accounts or groups of accounts, and controls to be tested.

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[7] Office of Chief Accountant, Division of Corporation Finance, Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports: Frequently Asked Questions (rev. Oct. 6, 2004).

[8] Rel. Nos. 33-8514; 34-50864 (Dec. 16, 2004). The advisory committee's website is at http://www.sec.gov/info/smallbus/acspc.shtml.

[9] Auditing Standard No. 2; *see also* A New Standard for Auditing Internal Control Over Financial Reporting, Covington & Burling Client Advisory (Mar. 26, 2004).

The auditor must test and evaluate both the design and the operating effectiveness of the selected controls in forming a conclusion as to the overall effectiveness of the registrant's internal control over financial reporting (see box).

Audit of Internal Control

To perform an audit of a company's internal control over financial reporting, the auditor must obtain evidence to determine whether such control is effective. To obtain the requisite evidence, Auditing Standard No. 2 requires the auditor, among other things, to:

- evaluate and test management's assessment process,
- evaluate and test some of the work on internal control performed by others, such as internal auditors, and
- test the effectiveness of internal control, including performing "walkthroughs" of significant control processes by tracing major classes of transactions from origination through accounting and control systems and inclusion in the consolidated financial statements.

Following the PCAOB's promulgation of Auditing Standard No. 2, its staff has issued a series of questions and answers addressing the interpretation and application of Auditing Standard No. 2. These include such issues as the scope and extent of testing of controls, evaluating deficiencies, using the work of others, assessing controls with respect to outsourced activities, and other matters.[10]

Recent SEC and PCAOB Statements

In April 2005, the SEC hosted a roundtable discussion on implementation issues under the Section 404 rules. Representatives of public companies, auditors and investors, members of the legal community and members of the PCAOB participated in the discussion.

The roundtable discussion generated a substantial amount of feedback from the key participants in the financial reporting process in light of their experience complying with the Section 404 rules and Auditing Standard No. 2. The feedback confirmed what had already been apparent, *i.e.* that implementing the new requirements under Section 404 and Auditing Standard No. 2 has been an enormous, and costly, challenge for public companies. After the roundtable event, the PCAOB stated flatly that "it is clear to us that the costs to date associated with implementation of Section 404 have been too high."[11] Several factors appear to have contributed to these high costs, including the sheer workload required to perform the documentation, testing and other new tasks in the first year, as well as a strain on the resources of both companies and auditors. In addition, the feedback demonstrated that during the first year of implementation, auditors tended to interpret the new rules and auditing standard in an overly careful and conservative manner for fear of failing to meet the new requirements. This approach, in turn, generally had the effect of increasing the workload.

In response to this feedback, the SEC and the PCAOB released separate statements providing their perspective on ways in which the implementation of the Section 404 rules and Auditing Standard No.

[10] Office of the Chief Auditor, Public Company Accounting Oversight Board, Auditing Internal Control Over Financial Reporting: Staff Questions and Answers (Jun. 23, 2004 (Questions 1 - 26); Oct. 6, 2004 (Questions 27 - 29); Nov. 22, 2004 (Questions 30 - 36); Jan. 21, 2005 (Question 37); and May 16, 2005 (Questions 38 - 55)).

[11] Public Company Accounting Oversight Board, Policy Statement Regarding Implementation of Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, PCAOB Rel. No. 2005-009 (May 16, 2005) (the "PCAOB Policy Statement").

2 can be improved.[12] The SEC and PCAOB statements, which were issued on the same day and reflect a unified message, urge companies and auditors to take a number of steps to improve both the effectiveness and efficiency of the internal control review process, in order to reduce the workload and cost of compliance in future years.

A number of themes and specific points in the SEC's and PCAOB's statements deserve mention.

Emphasis on "Top-Down, Risk-Based" Approach

The SEC and the PCAOB noted that one of the key causes of excessive compliance costs during the first year of implementation was that registrants (and their auditors) simply identified, documented and tested too many controls and processes. In many cases, it appears that after a large universe of controls was identified (often at great cost), the process then became a somewhat mechanistic "check the box" exercise of documenting and testing some (or all) of such controls. Both the SEC and the PCAOB have criticized this approach and urged registrants and their auditors instead to follow a "top-down, risk-based" approach.

Although the concepts "top-down" and "risk-based" in this context share the same objective of achieving a more effective and efficient assessment process, they mean slightly different things. The term "top-down" means a process of review that begins at the top, *i.e.* with company-level controls that have wide application across the enterprise. From there, the review moves down, sequentially, to significant accounts, significant processes, and finally, individual controls. Knowledge gained at each level of review is factored into the planning for the review at the next level.

Under a "risk-based" approach, proportionately greater emphasis and resources are devoted to higher-risk areas at each phase of the review, with not all accounts and controls meriting equal attention. Rather, management is to apply its experience and judgment to identify those elements of the financial statements that present significant risk of material misstatement and then to identify, document and test the controls relevant to such elements. Applying such judgment should normally result in a smaller amount of testing for a low risk account than for a high risk account, thereby leading to a more cost-efficient assessment process. In addition, auditors should defer, to some extent, to management's judgment with respect to these risk assessments.

The Concept of Reasonable Assurance

Under the SEC's Section 404 rules, management is required to assess whether the company's internal control over financial reporting is effective in providing *reasonable assurance* regarding the reliability of financial reporting. The statement by the SEC's staff reminds registrants that while "reasonable assurance" is a high level of assurance, it does not mean absolute assurance.[13] Moreover, the staff

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[12] *See* Commission Statement on Implementation of Internal Control Reporting Requirements (May 16, 2005); Office of Chief Accountant, Division of Corporation Finance, Securities and Exchange Commission, Staff Statement on Management's Report on Internal Control Over Financial Reporting (May 16, 2005); PCAOB Policy Statement. In addition to the PCAOB Policy Statement, the PCAOB's staff at the same time released additional questions and answers addressing Auditing Standard No. 2. *See* Office of the Chief Auditor, Public Company Accounting Oversight Board, Auditing Internal Control Over Financial Reporting: Staff Questions and Answers (May 16, 2005 (Questions 38 - 55)).

[13] The staff's statement notes that the "reasonable assurance" referred to in the SEC's Section 404 rules relates back to similar language in the Foreign Corrupt Practices Act of 1977. Section 13(b)(7) of the Securities Exchange Act of 1934 defines "reasonable assurance" and "reasonable detail" as "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs." The staff's statement also notes that the SEC has long held that "reasonableness" is not an "absolute standard of exactitude for corporate records."

has noted that while "reasonableness" is an objective standard, there may well be a range of judgments that a registrant might make in complying with the Section 404 rules that would be "reasonable" in the context of such rules. The staff's observation, perhaps an obvious one, is nonetheless important, because it emphasizes that standardized "one size fits all" models are not appropriate. The staff goes on to admonish auditors to keep an open mind in this area, recognizing that there is a range of reasonable conduct by registrants that should be deemed acceptable in the implementation of the Section 404 rules.

Scope of Assessment and Use of Professional Judgment By Auditors

A common observation regarding the implementation process to date is that overly conservative interpretations of the rules' requirements, coupled with a hesitancy by auditors to use professional judgment in evaluating management's assessment, has led to many cases where too many controls were identified, documented and tested. Here again, the SEC and the PCAOB recommend modulation.

In planning the scope of its assessment, management must identify significant accounts and processes for testing. Consistent with the "risk-based" approach described above, the SEC's staff urges registrants to use judgment, including a review of qualitative factors, in determining which accounts and processes should be selected for testing, and not to rely solely on quantitative factors or fixed dollar thresholds. The scope of assessment should be tailored to the company's particular business, assets and risks. The staff asks management to "step back" from focusing on the granular details of individual controls and instead consider whether *combinations* of previously identified individual controls might constitute the actual control that contributes to financial statement assurance. In this case, registrants might not need to identify, document and test each individual step in a broader control definition and could instead test the effectiveness of the combination of detailed steps that meet the broader control objective. Indeed, the staff explicitly states that management may determine that not every individual step comprising a control is required to be tested in order to determine that the overall control is operating effectively.

The PCAOB's statement strikes a similar theme. Just as management must tailor its scope of internal control assessment to the company's particular business, assets and risks, so must the auditor tailor its audit plan to address the particular nature and risks of the audit client. The PCAOB chides auditors who rely on standardized checklists instead of exercising judgment to focus their work on areas with higher risks of misstatement.

The Integrated Audit Concept

The PCAOB Policy Statement reminds auditors that Auditing Standard No. 2 contemplates an integrated audit, *i.e.* an audit of the company's internal control over financial reporting that is integrated with the audit of the company's financial statements. When coordinated effectively, the auditor's examination of internal control can be validated by findings in the financial statement audit. Moreover, integration of the two audits allows evidence and test results from either audit to be contributed to completion of both audits.

Smaller Public Companies

Both the SEC and the PCAOB have recognized the special burden placed on smaller public companies by the Section 404 rules and Auditing Standard No. 2. Studies and commentary have suggested that the Section 404 rules have a disparate cost impact on smaller companies.[14] There has also been a concern that the substantial burden and cost of complying with the Section 404 rules and other requirements of the Sarbanes-Oxley Act may lead smaller public companies to "opt out" of the public company reporting regime by delisting and/or going private, although there does not yet appear to be definitive evidence that such is the case.[15]

In recognition of the burdens and costs imposed on smaller companies, the SEC has twice delayed the compliance date with respect to the rules for non-accelerated filers. Also, in December 2004 the SEC established an advisory committee on smaller public companies, which is expected to focus much of its attention on Section 404 and related issues.

The SEC staff's statement notes that it will continue to assess the effects of the Section 404 rules on smaller public companies. In addition, at the request of the SEC's staff, a task force of COSO has been formed to develop additional guidance on applying the COSO framework for internal control over financial reporting to smaller companies.[16] The guidance provided by this task force would supplement the existing discussion in the COSO Report of the special considerations with regard to internal control over financial reporting for small- and medium-sized companies.

Communicating with Auditors

The feedback from both registrants and auditors indicated that many participants in the financial reporting process believe the Section 404 rules and Auditing Standard No. 2 have had a "chilling effect" on communications between registrants and their auditors, as registrants have been more hesitant to ask their auditors technical accounting, auditing and financial reporting questions. In addition, the feedback indicated that registrants have become more reluctant to provide their auditors with preliminary drafts of financial statements, which, due to their draft nature, may be more likely to contain errors. These trends seem to be based on a concern that such communications or sharing of early drafts might lead to the unwarranted identification of internal control deficiencies by the auditors.[17] In addition to these concerns by registrants, auditors have expressed a heightened concern that providing management with advice might impair their independence under the SEC's auditor

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[14] A report by the American Electronics Association estimated that Section 404 compliance costs represented about 2.5% of revenue for companies with annual revenue below $100 million, compared with about 0.5% of revenue for companies with annual revenue between $100 million and $500 million. American Electronics Association, Sarbanes-Oxley Section 404: The "Section" of Unintended Consequences and its Impact on Small Business (Feb. 2005).

[15] Although the number of "going private transactions" reported on Schedule 13E-3 filings increased from 122 in 2002 to 178 in 2003, they decreased to 118 in 2004.

[16] COSO is the Committee of Sponsoring Organizations of the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission. The COSO framework refers to the framework on internal control over financial reporting included in COSO's *Internal Control -- Integrated Framework* (1992) (the "COSO Report"). The COSO Report was supplemented in 1994 with an addendum to the section of the COSO Report on "Reporting to External Parties." More information about COSO is available on its website, http://www.coso.org. The SEC's adopting release for its rules under Section 404 specifically endorses the COSO framework as a suitable control framework, but also leaves open the possibility that other frameworks could be used, as long as they satisfy the due process criteria set forth in Rules 13a-15(c) and 15d-15(c) under the Securities Exchange Act of 1934 .

[17] Auditing Standard No. 2 provides, among other things, that an auditor's discovery of a material misstatement in financial statements is a "strong indicator" of a material weakness in internal control.

independence rules. Among other things, those rules provide that the auditor cannot function in the role of management or audit his or her own work.[18]

This chilling effect on communications clearly concerns both the SEC and the PCAOB. In its statement, the SEC's staff notes that an auditor's discussing and exchanging views with management does not, by itself, violate the SEC's auditor independence rules and that investors benefit when registrants engage in dialogue with their auditors regarding the appropriate accounting treatment for complex or unusual transactions. The staff goes on to say that such dialogue with the auditor is appropriate and is not, in and of itself, indicative of an internal control deficiency, so long as management, and not the auditor, makes the final determination regarding the accounting to be used (including with respect to key estimates and assumptions) and the auditor does not design or implement the registrant's accounting policies.

Regarding the provision of draft financial statements to auditors, both the PCAOB and the SEC's staff strongly encourage the sharing of draft financial statements with auditors on a timely basis, better to promote communication between registrant and auditor. An error in draft financial statements should not, in and of itself, be the basis for determining whether a control deficiency exists. Rather, management and auditors should determine whether a deficiency exists in the processes of preparing financial statements. As the PCAOB Policy Statement makes clear, auditors should be concerned primarily about cases where the registrant *completes* its financial statements without recognizing a potential material misstatement. If a misstatement is identified in draft financial statements but it is clear that all of the registrant's applicable controls have not yet operated, it would be premature for the auditor to conclude that a control deficiency exists.

Other Items Addressed by the SEC and PCAOB

The recent statements by the SEC, its staff and the PCAOB include a number of other noteworthy points regarding the rules governing internal control over financial reporting.

- The SEC's staff noted that not all restatements resulting from an error demand the finding of a material weakness in internal control over financial reporting. Rather, in such cases, both management and the external auditor should use their judgment in assessing the reasons why a restatement was necessary and whether the need for restatement resulted from a material weakness in control.

- The SEC's staff noted that management may be able to test a substantial number of controls at a point in time *prior* to fiscal year-end, thereafter through ongoing monitoring of such controls determining that they also function effectively as of the fiscal year-end date, without performing further detailed testing.

- The PCAOB urged that auditors take advantage of the significant flexibility in Auditing Standard No. 2 to use the work of others, particularly in areas of lower risk.

- The SEC's staff said a registrant that discloses the existence of a material weakness in its annual report should consider including with such disclosure the nature of such material weakness, the impact of such material weakness on financial reporting and the control environment, and management's current plans, if any, for remediating the weakness.

[18] *See* Preliminary Note to Rule 2-01 of Regulation S-X.

- The SEC's staff said that, for purposes of Section 404 assessment, it expects registrants to document and test only *relevant* general information technology ("IT") controls, and it would not expect registrants to test general IT controls that do not pertain to the financial reporting process.

- The SEC's staff rejected the suggestion that it issue new guidance allowing management to exclude new IT systems and upgrades implemented in the later part of a fiscal year from the scope of management's assessment for that year.

- The SEC's staff is continuing to assess the effects of the internal control reporting requirements on foreign private issuers.

Conclusion

The managements of most larger U.S. public companies have now completed their initial assessments of internal control over financial reporting as required by the SEC's rules under Section 404, and their companies' auditors have now conducted initial audits of internal control in accordance with Auditing Standard No. 2. It is undeniable that the initial implementation phase has imposed substantial costs on public companies. Indeed, the costs have exceeded expectations, which were high to begin with.

Nonetheless, the new rules do seem to be having a beneficial impact.. As noted by the SEC, the new rules and auditing standard have produced a heightened focus on internal control at the top levels of public companies, which, in turn, should be expected to improve the financial reporting process.[19] In addition, from a disclosure perspective, the evidence suggests that more registrants are including disclosure regarding material weaknesses than in prior periods and that the quality of disclosures regarding internal control over financial reporting is improving.[20] It is likely that these trends will continue.

The SEC's and PCAOB's recent statements demonstrate the regulators' sensitivity to the great challenges imposed by the Section 404 rules and the new auditing standard. The unified message from the SEC and the PCAOB is helpful and encouraging in that it endorses a practical, risk-based approach to applying the new rules. Although the SEC's and the PCAOB's statements do not offer any formal or specific relief from the requirements of the new rules, their endorsement of the use of professional judgment and a reasoned approach to application of the rules is a welcome development.

Ongoing implementation of the Section 404 rules and Auditing Standard No. 2 will continue to present challenges, however. In the area of communications between registrants and auditors, the SEC's and PCAOB's forceful encouragement of open dialogue between registrants and auditors, while helpful, without more may not be enough to counteract risk aversion. Clearly the landscape has changed dramatically, and, as a practical matter, there remains substantial uncertainty amongst registrants and

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[19] The PCAOB Policy Statement noted that 79% of the 222 financial executives surveyed by Oversight Systems, Inc. reported that their companies have stronger internal control after complying with Section 404. *See* Oversight Systems, Inc., The 2004 Oversight Systems Financial Executive Report on Sarbanes-Oxley (December 2004).

[20] For example, the "Big Four" accounting firms reported that as of March 31, 2005, approximately 140 calendar year-end companies had reported material weaknesses. This report also estimated that about 10% of the public companies currently required to include Section 404 assessments as part of their annual reports will disclose one or more material weaknesses that were unremediated as of the end of their fiscal year. *See* Letter, dated April 11, 2005, to the SEC, from Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP. In addition, in remarks made after the release of the SEC's and staff's statements, Paul Dudek, head of the SEC's Office of International Corporate Finance, noted that about 8% of all internal control reports that have been filed with the SEC included disclosure of one or more material weaknesses.

auditors as to the new boundaries, norms and practices in communicating with each other. Registrants are also likely to continue to be concerned about the practical challenges for internal control assessment posed by ongoing IT systems upgrades. Finally, it remains to be seen whether the new rules can be implemented by smaller public companies and foreign private issuers in a manner that does not impose overly disproportionate costs and burdens on such companies. Both the SEC and the PCAOB seem poised to do more. In a recent speech, the SEC's Chief Accountant, Donald Nicolaisen, has spoken of needing to "strike the right balance" in this area and said that "if additional guidance is necessary, we will consider providing it."[21] This is a good thing, because although there has been significant progress toward enhanced internal control over financial reporting, much remains to be done in terms of setting a clearer course.

David B.H. Martin
David H. Engvall

If you have any questions concerning the material discussed in this client advisory, please call the following members of our securities practice group:

David Martin	202.662.5128	dmartin@cov.com
Bruce Bennett	212.841.1060	bbennett@cov.com
Andrea Vachss	415.591.7069	avachss@cov.com
Edward Britton	+44.(0)20.7067.2119	ebritton@cov.com

[21] *See* Remarks of Donald T. Nicolaisen, Chief Accountant, before the University of Southern California Leventhal School of Accounting: SEC Financial Reporting Institute Conference (Jun. 2, 2005) http://www.sec.gov/news/speech/spch060205dtn.htm.