

## **Section 404, SEC Rules and PCAOB Auditor Standards Define New Internal Controls**

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To enhance the quality of reporting and increase investor confidence, Section 404 of the Sarbanes-Oxley Act requires that annual reports filed with the SEC must be accompanied by a management statement that management is responsible for creating and maintaining adequate internal controls. Management must also present its assessment of the effectiveness of those controls.

In addition, the company's auditor must report on and attest to management's assessment of the company's internal controls. High quality audits typically incorporate extensive internal control testing. Congress intends that the auditor's assessment of the company's system of internal controls should be considered to be a core responsibility of the auditor and an integral part of the audit report. The new Public Company Accounting Oversight Board was charged with developing the auditor attestation standard.

SEC rules implementing Section 404 require companies to include in their annual report a report of management on the company's internal control over financial reporting.

The report must include:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting;
- A statement identifying the framework used to evaluate 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;
- A statement that the outside auditor that audited the company's financial statements included in the annual report has issued an attestation report on management's evaluation of the company's internal control over financial reporting.

The rules become effective for accelerated filers on November 15, 2004. For companies that are not accelerated filers, and for foreign private issuers, the effective date is July 15, 2005.

The PCAOB has proposed a new standard requiring auditors to communicate in writing to the company's audit committee all significant deficiencies and material weaknesses of which the auditor is aware. Auditors are also required to communicate in writing to the company's management all internal control deficiencies of which they are aware and to notify the audit committee that such communication has been made. When adopted by the PCAOB, expected in March 2004, the new standard is subject to SEC approval.

[CCH's Guide to Internal Controls](#) examines and discusses the interaction of Section 404, the SEC rules, and the new PCAOB auditor standard. In addition, best practices in this area will be set forth.