

THE CENTER FOR PUBLIC COMPANY AUDIT FIRMS
SEC Regulations Committee
September 13, 2005 - Joint Meeting with SEC Staff
SEC Offices – Washington DC

HIGHLIGHTS

NOTICE: The AICPA SEC Regulations Committee meets periodically with the staff of the SEC to discuss emerging technical accounting and reporting issues relating to SEC rules and regulations. The purpose of the following highlights is to summarize the issues discussed at the meetings. These highlights have not been considered and acted on by senior technical committees of the AICPA, or by the Financial Accounting Standards Board, and do not represent an official position of either organization.

In addition, these highlights are not authoritative positions or interpretations issued by the SEC or its Staff. The highlights were not transcribed by the SEC and have not been considered or acted upon by the SEC or its Staff. Accordingly, these highlights do not constitute an official statement of the views of the Commission or of the Staff of the Commission.

I. ATTENDANCE

A. SEC Regulations Committee

Jay Hartig, Chair
Gerard Brinkman
Jack Ciesielski
Greg Clifton
Melanie Dolan
Clarence Ebersole
David Follett
Karin French
Steve Henning
David Hinshaw
Chris Holmes
Jeff Lenz
Scott Pohlman
Amy Ripepi
John Riley
John Wolfson

B. Securities and Exchange Commission

Office of the Chief Accountant

Don Nicolaisen, Chief Accountant
John Albert, Senior Associate Chief Accountant
Edmund W. Bailey, Senior Associate Chief Accountant
Jennifer Burns, Professional Accounting Fellow
Robert Burns, Chief Counsel
Cathy Cole, Associate Chief Accountant
Greg Cross, Assistant Chief Accountant
Julie Erhardt, Deputy Chief Accountant
Mike Gaynor, Professional Accounting Fellow
Len Jui, Assistant Chief Accountant
Mike Kigin, Senior Associate Chief Accountant
Timothy Kviz, Professional Accounting Fellow
Cheryl Linthicum, Academic Fellow
Tony Lopez, Associate Chief Accountant
Joseph McGrath, Professional Accounting Fellow
Jennifer Minke-Girard, Senior Associate Chief Accountant
Brian Roberson, Professional Accounting Fellow
Esmeralda Rodriguez, Associate Chief Accountant
Nancy Salisbury, Senior Associate Chief Accountant
Pam Schlosser, Professional Accounting Fellow
Charlotte Thomas, Research Specialist
Cheryl Tjon-Hing, Valuation Specialist
Teri Yohn, Academic Fellow

Division of Corporation Finance

Carol Stacey, Chief Accountant
Craig Olinger, Deputy Chief Accountant
Louise Dorsey, Associate Chief Accountant
Stephanie Hunsaker, Assistant Chief Accountant
Todd Hardiman, Associate Chief Accountant
Jonathan Ingram, Deputy Chief Counsel
Joel Levine, Associate Chief Accountant
Andrew McLelland, Academic Fellow
Rachel Mincin, Associate Chief Accountant
Leslie Overton, Associate Chief Accountant
Michael Stehlik, Business Associate
Sondra Stokes, Associate Chief Accountant

Division of Enforcement

Charles Wright, Senior Legal Advisor

Division of Investment Management

Brian Bullard, Chief Accountant
Toai Cheng, Assistant Chief Accountant

C. AICPA Center for Public Company Audit Firms

Lillian Ceynowa
Annette Schumacher Barr

D. Guests

Bob Guido, PwC

II. OPENING REMARKS

Don Nicolaisen opened the meeting by highlighting the following priorities that are currently being addressed by the SEC staff, adding that he hopes to finalize as many open items as possible before his departure from the Commission at the end of October 2005:

A. Use of Market Instruments in Valuing Employee Stock Options

On September 9, 2005, SEC Chairman Christopher Cox announced the issuance of informal SEC staff progress reports on the ongoing Commission evaluation of proposals to value employee stock options for financial reporting purposes. (See <http://www.sec.gov/news/press/2005-129.htm>) Mr. Nicolaisen also issued a statement regarding the use of market instruments to estimate the grant-date fair value of employee stock options. (See <http://www.sec.gov/news/speech/spch090905dtn.htm>). In the statement, Mr. Nicolaisen refers to an analysis performed by the Commission's Office of Economic Analysis (OEA) which considers alternative market-based approaches to valuation under FASB Statement 123R, focusing on the design of a market instrument.

The OEA memo can be found at
<http://www.sec.gov/news/extra/memo083105.htm>

Commenting on the OEA memo, Mr. Nicolaisen stated that that he would encourage companies to use a valuation model for financial reporting purposes until market exchange approaches can be further refined and understood. In his view, he would encourage that registrants that issue these types of instruments consider making disclosures to explain the design and marketing of the instruments and the possible reasons for any significant differences in indicated values (traded instrument vs. valuation model). Additionally, Mr. Nicolaisen noted that such approaches could be used by

registrants to supplement and support the amount determined using a valuation model.

B. Materiality

The Office of the Chief Accountant expects to issue guidance on the evaluation of out of period items prior to year end; if issued in the near term, this guidance is expected to be applicable for December 31, 2005 financial statements. Mr. Nicolaisen stated that this project focuses on the measurement aspect of errors to be assessed for materiality and the SEC Staff's views on the use of the so-called "iron curtain" and "rollover" methods of quantifying departures from GAAP. The guidance is expected to be released as a Staff Accounting Bulletin and would provide transition guidance to registrants. Reference should be made to the December 2004 speech by Russell Hodge for an understanding of the SEC staff's recent thinking on the iron curtain and the rollover methods. *This speech is available at <http://www.sec.gov/news/speech/spch120604rph.htm>*

C. International Financial Reporting and US GAAP

As a result of legislation in the European Union, certain large European companies are required to adopt International Financial Reporting Standards (IFRS) in their 2005 financial statements. Accordingly, the primary financial statements reported in Form 20-F filings as of December 31, 2005 for these companies will reflect that initial application of IFRS and the related reconciliation of IFRS to US GAAP. The SEC staff plans to study the initial reporting under IFRS by these foreign registrants to understand how IFRS is being applied and the types of US GAAP adjustments that arise.

Mr. Nicolaisen expressed his view that there should be no need for U.S. companies making cross-border offerings to reconcile from U.S. GAAP to IFRS, as described in the proposed EU equivalency standard which the SEC Staff will communicate to representatives of The Committee of European Securities Regulators (CESR).

D. XBRL Technology

Mr. Nicolaisen stated his view that XBRL provides the potential for timely, transparent and comparable financial reporting and that XBRL implementation has been an important topic for the SEC Staff. The SEC Staff is currently in the process of implementing systems to facilitate the timeliness, tracking and monitoring of XBRL information. He noted his appreciation for all the efforts put forth by the SEC Staff to further this initiative and expressed enthusiasm about the progress made thus far.

E. Elimination of Complexities in Accounting Standards

Mr. Nicolaisen stated the current complexity of accounting standards needs to be reduced. He further commented that the standard-setting community should intensify efforts to eliminate these complexities. He stated that an annual 10% restatement rate for registrants was “far too high.”

F. Compliance with Section 404 of the Sarbanes-Oxley Act of 2002

Mr. Nicolaisen reported that the SEC Staff is working to ensure that reporting on internal controls over financial reporting under Section 404 of the Sarbanes-Oxley Act is functioning as intended. Based on input received by Commission from various sources, he stated his belief that there is a general support for strong internal controls and that even the harshest critics of internal control reporting have acknowledged the need for (and the benefits of) improvements in internal controls. He also stated that he expects this coming year’s audits of internal controls to run more smoothly than the initial audits that occurred last year. The SEC staff also hopes to see improved communications between registrants and auditors regarding internal control related issues.

G. Internal Controls for Smaller Businesses

Mr. Nicolaisen stated his view that smaller businesses (including micro-cap companies) have a critical need for a framework to evaluate internal controls in a cost effective manner. To that end, the SEC staff has encouraged COSO to develop an internal control framework for smaller businesses. COSO is addressing this topic but their work may not be complete for another 5-6 months.

Mr. Nicolaisen stated that the Commissioners and SEC staff are very interested in understanding the challenges faced by smaller companies in reporting on internal controls. The Commissioners may seek public input on how to handle internal control reporting for smaller companies, particularly micro-cap companies who appear to face the most significant challenges. *(Note: On September 22, 2005, the SEC issued a release deferring the effective date of internal control reporting for nonaccelerated filers, i.e. for issuers with less than \$75 million in market capitalization. In addition to deferring the effective date until fiscal years ending on or after July 15, 2007, the release seeks public comment on issues related to implementation of internal control reporting and audits of internal controls for smaller businesses. See <http://www.sec.gov/rules/proposed/33-8617.pdf>)*

H. Audit Committee Assessment of Auditor Independence

Mr. Nicolaisen noted that one of the priorities in the Office of the Chief Accountant is developing information to assist audit committees with their assessment of auditor independence. Mr. Nicolaisen observed that audit committees often look to their audit firms for guidance regarding auditor

independence; he believes this information should be more readily available from the SEC. Deputy Chief Accountant Andy Bailey is working on this initiative.

I. Structured Transactions

Consistent with the views stated in the SEC Staff's report on off-balance sheet transactions released in June 2005, the SEC Staff continues to ask questions of registrants that enter into structured transactions. Mr. Nicolaisen noted that while some structured transactions are entered into to fill a real business need, others are done solely for accounting purposes. That latter population of transactions is a source of concern to the SEC staff. Mr. Nicolaisen stated that when these types of structured transactions are discovered, the Staff will require restatement if these transactions are not accounted for in accordance with GAAP. Deputy Chief Accountant Scott Taub will spearhead the SEC Staff's efforts in this area.

III. DIVISION UPDATES

A. Office of the Chief Accountant (OCA) Update

Jack Albert noted the following personnel changes in OCA:

- Four new PAFs joining the staff for two-year terms beginning this summer are Timothy S. Kviz, Joseph B. Ucuzoglu, Michael G. Gaynor and Joseph D. McGrath. Outgoing PAFs are Robert J. Comerford, Russell P. Hodge, John M. James, and Chad A. Kokenge. In addition, Cheryl Linthicum, Mark Taylor and Teri Yohn joined the staff as Academic Accounting Fellows for one-year terms that began August 2005.
- A new 2 year program in OCA was recently initiated -"General Business Associates" – these individuals will assist in the research and drafting of OCA positions and projects.
- Jane Poulin has left the Commission to take a position in industry.

B. Division of Corporation Finance (Corp Fin) Update

Carol Stacey provided the following update of activities in the Division of Corporation Finance:

- Staffing Update

The Division employs approximately 250 accountants although a few staff members are in the process of retiring. The Division plans to post an opening for another Associate Director soon. New academic fellow Andy McLelland joined the Division staff in August 2005.

- Reviews of Registrant Filings

Staff members are in the process of reviewing filings with the expectation of meeting its September 30, 2005 internal deadlines (The Sarbanes-Oxley Act of 2002 mandates that the Division complete reviews of all public companies at least once every three years). Ms. Stacey observed that with the issuance of the Securities Offering Reform, the Staff will likely not review registration statements for "Well Known Seasoned Issuers" that are automatically effective upon filing. Rather, the staff will focus on the periodic reports (Form 10-K and Form 10-Q) for those companies.

- Relief for Companies Affected by Hurricane Katrina

Ms. Stacey stated that 54 registrants were identified as being significantly affected by Hurricane Katrina, 72% of which are audited by Big 4 firms. The Commission is planning various types of relief involving filing deadlines, proxy delivery, record retention/re-creation, confirmations, independence requirements, etc. Special issues, including the ability to comply with 404 requirements, and potential relief for other companies that were impacted by this disaster, will be reviewed on a case by case basis. *Note: Subsequent to this meeting, on September 15, 2005, the Commission issued an order providing emergency regulatory relief to investors, companies, and securities firms affected by Hurricane Katrina. (See <http://www.sec.gov/news/press/2005-132.htm>)*

- Delay of Section 404 of the Sarbanes-Oxley Act of 2002 for Non-Accelerated Filers

Ms. Stacey noted that she could not comment on the September 13, 2005 Wall Street Journal article that stated 404 may be delayed another year for such companies but did state that the staff was examining the issue. *Note: As discussed above, subsequent to the meeting, on September 22, 2005, the SEC issued a release deferring the effective date of internal control reporting for nonaccelerated filers. See <http://www.sec.gov/rules/proposed/33-8617.pdf>*

- Executive Compensation Disclosures

Ms. Stacey noted that Statement 123(R) now provides a basis for improved, integrated disclosure about the total amount of executive compensation. However, it is unlikely that any revisions to the SEC's executive compensation disclosure rules would be effective for the Spring 2006 proxy season.

- Division of Corporation Finance Staff Training Manual

Ms. Stacey reported that the staff has continued to make progress in updating the Staff Training Manual during the summer of 2005. It is

uncertain at this point: (1) whether the update will be completed by year end and (2) how the training manual will be made publicly available.

- Division of Corporation and Finance Current Accounting and Disclosure Issues document

Ms. Stacey stated that the staff is planning to update this document in October or November 2005.

- 1934 Act Accelerated Filing Deadlines

The final phase of accelerated filing deadlines are scheduled to become effective in 2006. With respect to the upcoming accelerated Form 10-Q filing deadline (from 40 days after quarter end to 35 days), Ms. Stacey noted that the SEC staff has received feedback that this deadline may be difficult for some accelerated filers. Some companies have cited required preparation time, internal management and board and audit committee review as reasons for the difficulty in meeting the new 35 day deadline.

With respect to the upcoming accelerated Form 10-K deadline (from 75 days after year end to 60 days), Ms. Stacey stated that larger companies have indicated they could meet (and many have met) the 60 day deadline. However, other companies have indicated that meeting the accelerated Form 10-K timing may be problematic. The Commissioners may consider some relief in response to these concerns. *(Note: Subsequent to the meeting, on September 22, 2005, the Commission issued a proposal related to accelerated filings of 10-Ks and 10-Qs. The proposal would create a new category of accelerated filer (large accelerated filer), defined as having public float of \$700 million or more. Large accelerated filers would be required to comply with the 60-day deadline for annual reports on Form 10-K. However, no further acceleration for Form 10-K would be required for other accelerated filers. Additionally, the Commission is proposing to eliminate the final phase of acceleration for Form 10-Q for all accelerated filers. Refer to the full text of the SEC's proposal at the following link: <http://www.sec.gov/rules/proposed/33-8617.pdf>*

- Transition Guidance for the Securities Offering Reform

Ms. Stacey stated that the staff has indicated it will issue transition guidance in the near term. *(Note: Subsequent to the meeting, on September 13, 2005, the staff issued this guidance. It is available at the following link: <http://www.sec.gov/divisions/corpfin/transitionfaq.htm>* <

In addition, the CorpFin legal staff issued on November 30, 2005 an additional FAQ document regarding securities offering reform implementation issues. It is available at the following link: http://www.sec.gov/divisions/corpfin/faqs/securities_offering_reform_qa.pdf

The Committee asked if the new requirement to disclose significant unresolved SEC staff comments will affect the timing of staff reviews. The SEC staff stated there is no planned effect on comment letter timing or procedures; however, the SEC staff as well as registrants should be mindful of the deadline to resolve comments. The staff hopes the new disclosure created as a part of the securities offering reform initiative will encourage improvement on both sides in the resolution of outstanding comments.

- **Public Release of Comment Letters and Registrant Responses**

Although the process of posting comment letters and responses continues, it is moving slowly due to confidential treatment redaction issues. The staff is currently working on a redaction software fix.

Ms. Stacey further commented that the SEC Staff will issue letters to registrants when the review of the filing is completed and that comment letters and related registrant responses are subject to posting to the SEC's website 45 days after the date of the completion letters.

C. Enforcement Update

Charles Wright provided the following update of activities in the Division of Enforcement:

- **Recent Organizational and Staff Changes**

The Enforcement Division has approximately 100 accounting staff across the country, including 34 at the Washington D.C. Headquarters.

- **Recent Enforcement Cases and Investigations**

Financial fraud is still a priority for the Division. The Division continues to take referrals from the Division of Corporation Finance and tips from the website.

- **Material Weaknesses/Reports under Section 404 of the Sarbanes-Oxley Act of 2002**

Mr. Wright stated that the Enforcement Division does not have an overall policy regarding material weaknesses or delinquent or untimely 404 filings. The Enforcement Division staff deals with the Division of Corporation Finance and the Office of the Chief Accountant to address these issues on a facts and circumstances basis. Jonathan Ingram stated that the Division of Corporation Finance will involve the Enforcement Division if necessary but to date, no delinquent 404 filers have been referred to the Enforcement Division.

D. Investment Management (IM) Update

Brian Bullard provided the following update of activities in the Division of Investment Management:

- Recent Organizational and Staff Changes

One IM staff member has left the Division and returned to industry. It is uncertain whether the position will be filled. The Division also continues to operate under an Interim Director.

- Investment Company Complex and Private Equity Funds – Independence Rules

Mr. Bullard stated that his staff is studying this area in the hopes of providing guidance. He added that there should be a common answer for both independence situations. With respect to the format of the guidance, two options are being considered: i) new rulemaking that would change the existing definition or ii) a staff interpretation clarifying what the staff's intentions were when drafting the original rulemaking. Mr. Bullard hopes to discuss the issue with Mr. Nicolaisen in the next month. It is unlikely that any guidance will be issued before December 31, 2005.

- Auditing Standards for Financial Statements of Insurance Company Depositors of Variable Insurance Products

Mr. Bullard stated that both formats of audit opinions continue to be acceptable (See <http://www.sec.gov/divisions/investment/letters030805.htm>). It is not likely that any new guidance changing this position will be issued this year.

- Business Development Companies

Mr. Bullard commented that the Division had noted a number of compliance and enforcement issues involving registered business development companies (BDC's). Mr. Bullard observed that the incidence of problems may be due to the fact that BDC's report using Form 10-K and Form 10-Q, but must comply with investment company accounting rules. Bullard speculated that the personnel assigned to BDC audits may be unfamiliar with those rules and may be inappropriately applying Regulation S-X.

IV. NEW ISSUANCES/RELEASES

A. Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers

In response to a question, the staff noted that other than off-balance sheet disclosures, it does not expect to use this release as a basis to issue comments to registrants.

B. Guidance issued for “Consulting on Accounting Matters with the Office of the Chief Accountant”

The SEC staff noted that clarifying changes have recently been made to this guidance. The SEC staff added that this guidance has helped expedite timely responses to registrants’ questions and that it is also to be used when seeking guidance in auditing and independence consultations.

With respect to communicating inquiries to the SEC staff, Carol Stacey noted that certain companies are sending questions to the Division of Corporation Finance electronic letterbox. She stated that it would be better to fax questions directly to the Division at 202-772-9213 as there is a delay necessitated in clearing and distributing the letterbox.

C. New requirements to disclose in periodic reports penalties associated with an IRS “listed transaction” (arising from IRS Revenue Procedure 2005-51)

The IRS rules are effective for tax returns filed after October 22, 2005. Accordingly, the new disclosure requirements would be included in Form 10-K's filed after that date. No guidance is expected to be issued by the SEC staff related to these new IRS disclosure requirements.

V. STATUS UPDATE OF PROJECTS/ISSUES

A. Compilation of SEC Regulations Committee Meeting Highlights

The Committee provided the staff with a copy of the draft compilation that incorporates joint meeting discussion documents from the 1994 through the 2005 highlights issued to date. The draft compilation, which is organized by rule/regulation, contains numerous superseded discussion documents. The Committee would like to retain this superseded information, either by highlighting or moving the information to a separate section of the compilation. The committee requested the staff review the document and provide input on its organization and information the staff believes should be labeled as superseded. The goal is to have a document that would be posted to the AICPA website to be used for research by interested parties.

The staff agreed to conduct the review but stated that the Staff Training Manual will take priority over the compilation.

VI. CURRENT PRACTICE ISSUES

Discussion Document A

Topic: Disclosure Controls and Procedures

In the event a registrant's management determines that one or more material weakness(es) in internal control over financial reporting exists as of its balance sheet date, the auditor typically expects that the registrant will conclude that its disclosure controls and procedures are ineffective as of the same date. Frequently outside securities counsel for a registrant in this situation maintains that material weaknesses that relate to internal control over financial reporting (including in situations in which there has been a material error in the financial statements resulting in audit adjustments and/or the restatement of previously issued financial statements) do not equate to ineffective disclosure controls and procedures.

PCAOB AU 550, requires an auditor to read "other information" in a document that contains audited financial statements and the independent auditor's report thereon, and provides guidance to an auditor that identifies a material misstatement of fact in the other information or a material inconsistency between the other information and the financial statements. PCAOB Auditing Standard No. 2 extends the concept in PCAOB AU 550 regarding a material misstatement of fact to reports on internal control over financial reporting. (See paragraph 192 of PCAOB Audit Standard No. 2).

PCAOB AU 722 has similar requirements relating to other information in a report containing the interim financial information that an auditor has reviewed. PCAOB FAQ 55 indicates that the auditor's responsibilities related to management's quarterly certifications on internal control are analogous to the auditor's responsibilities related to the company's financial statements in an interim review in accordance with PCAOB AU 722.

In response to the question "...can a CFO/CEO reach a position in their section 302 certifications that disclosure controls and procedures are effective at a reasonable assurance level, even though there is an identified material weakness in internal control over financial reporting?", Alan Beller responded "I think the threshold for a CEO and a CFO to reach that conclusion is a high one. The reason I say that is that the concept of material weakness in the area of internal control is ultimately a weakness that leads to a more than remote likelihood of a material misstatement. And PCAOB Audit Standard No.2 makes it clear that at least in some circumstances, in evaluating whether there is a material weakness, one may take into account countervailing controls. So once you've found that there's a material weakness, the CEO and the CFO are going to have to conclude that, notwithstanding that material weakness and notwithstanding that the countervailing controls were already taken into account in determining that there

was a material weakness, nonetheless, management can reach a conclusion with reasonable assurance that disclosure controls are effective. “ He added that “if management is going to conclude this for purpose of its certification, there’s a place to make disclosure about how one gets to those conclusions in 10-Ks and 10-Qs, and we will expect management, if there is a material weakness in internal control and management nonetheless believes that disclosure control is effective, that they will make that clear, and to explain why. We have been giving that comment. We’re not looking for five pages of boilerplate; we’re looking for something which is succinct and convincing that the analysis has been made and that management has reached the conclusion that it’s standing behind it.” (Source: Transcripts of RR Donnelley Conference “SEC, PCAOB Internal Controls over Financial Reporting: New Regulations” held on July 20, 2004. See <http://www.realcorporatelawyer.com/programs.html#tele0720> for transcripts.)

We are aware of one instance in which the Staff reviewed a registrant’s disclosure of multiple material weaknesses in internal control over financial reporting as of the audited balance sheet date yet did not object to the registrant management’s conclusion that disclosure controls and procedures were effective.

What does the Staff consider in reviewing management’s conclusions as to the effectiveness of disclosure controls and procedures?

Staff Response: The SEC Staff has not issued guidance on this matter. The SEC Staff approaches this issue in the same manner as other disclosure requirements: look at what the registrant discloses, ask questions if necessary to understand the facts and circumstances, assess the reasonableness of management’s conclusion, and evaluate whether the disclosure is sufficiently robust and transparent. The SEC staff acknowledged Alan Beller’s statement that “the threshold for a CEO and a CFO to reach that conclusion is a high one” but also acknowledged that facts and circumstances would determine whether management could conclude that its disclosure controls and procedures were effective despite the existence of a material weakness in internal controls over financial reporting. To date, the SEC staff noted that approximately 92% of registrants that have identified one or more material weaknesses in internal controls have also concluded that their disclosure controls and procedures were not effective.

VII. PRACTICE ISSUES FROM THE JUNE 14, 2005 JOINT MEETING (ATTACHED)

- Prior Attachment E - Withdrawal of Management’s Report on Internal Control Over Financial Reporting on Item 4.02 8-K
 - Additional Committee Questions for Staff Response
- Prior Attachment F - Status update of the chart on what types of reports should refer to PCAOB standards and what firms are required to be registered
 - Interpretative Examples for Staff Response

PRIOR ATTACHMENT E:

Topic: Withdrawal of Management's Report on Internal Control over Financial Reporting on Item 4.02 8-K

Background: When a registrant concludes that previously issued financial statements should no longer be relied on because of an error or when the registrant is advised by, or receives notice from, its independent accountant that disclosure should be made or action should be taken to prevent future reliance on a previously issued audit report or completed interim review, an Item 4.02(a) and Item 4.02(b), respectively, Form 8-K should be filed by the registrant within four business days.

In addition to other required disclosures under Item 4.02(a) and Item 4.02(b), the Form 8-K must include disclosure of the date of the conclusion regarding the non-reliance and an identification of the financial statements and years or periods covered that should no longer be relied upon.

After a company has reported on its internal control over financial reporting, if it needs to restate its financial statements, the Committee believes the company will need to consider the need to restate its management report on internal control over financial reporting.

Question: When a registrant files an Item 4.02 Form 8-K to prevent future reliance on previously issued financial statements or an audit report included in a Form 10-K and that contains management's report on internal control over financial reporting, should the Form 8-K address the internal control report as well?

Committee Recommendation: The Committee believes that the Form 8-K should include explicit disclosure by the registrant that communicates:

- Whether a material weakness in internal control was identified in connection with the restatement and
- Whether management's conclusions about the effectiveness of the company's internal control over financial reporting have changed.

Staff Response: The Staff commented that the Form 8-K rules do not require such disclosure. The Staff stated that the primary purpose of Item 4.02 is to communicate to financial statement users that the financial statements should no longer be relied upon; the item requirements do not address and were not intended to address internal control over financial reporting. The Staff commented that it is the registrant's decision what disclosures (i.e. regarding material weakness(es)) to include in its Item 4.02 8-K regarding internal control over financial reporting.

In the discussion of this topic, the following scenario was discussed:

Facts:

- A calendar year-end accelerated filer files its December 31, 2004 Form 10-K in March 2005 which includes management's report on internal control over financial reporting.
- In October 2005, the registrant discovers an error in its financial statements and concludes that the error resulted from a material weakness that existed at December 31, 2004.
- As a result, the registrant will amend its 2004 Form 10-K (file a Form 10-K/A) and file restated financial statements and related information.

In this example, the Staff commented that SEC's rules do not require a registrant to make a full reassessment of its report of internal control over financial reporting; the rules require the registrant to make only one assessment at its year-end balance sheet date (in addition, the Staff stated that while audit standards require the auditor to consider the need to revise its opinion on internal control over financial reporting in this example, the SEC's rules do not have a similar requirement). The Staff commented, however, that the registrant would have to address disclosure of the material weakness(es) in its 2004 Form 10-K/A in conjunction with its S-K Item 307 and 308(c) disclosures. Item 307 disclosures might need to be changed to state that disclosure controls and procedures were not effective as of December 31, 2004, and Item 308(c) disclosures might need to be changed to state that a material weakness in internal control over financial reporting was identified subsequent to December 31, 2004. The Staff further commented that, in accordance with Section AU 561 of the *Codification of Statements on Auditing Standards*, an auditor would need to issue a revised report on the registrant's internal control over financial reporting for inclusion in the 10-K/A. The staff observed that, although the registrant is not required to reassess its report on internal control over financial reporting, it may elect to do so, since the registrant would likely want an unqualified opinion on management's assessment of internal control over financial reporting from its auditors upon reissuance of the auditor's opinion. This would prompt the registrant to issue a revised management report on internal control over financial reporting.

The staff further observed that if, at the time of the filing of an Item 4.02 8-K, a registrant's auditor has advised it that it will be issuing a revised audit report on the registrant's internal control over financial reporting, the registrant should consider whether the Item 4.02 8-K would be materially misleading if it did not disclose that fact.

Additional Committee Question: *The committee seeks the staff's clarification of the following additional question:*

Question 1: Is the registrant required to reassess the effectiveness of internal control over financial reporting under Item 308(a) in connection with a restatement on Form 10-K/A?

View A – Yes. A registrant that becomes aware that the prior conclusion reached was incorrect as a result of the failure to identify a material weakness that existed as of the balance sheet date must revise such report. Although the rule only requires the assessment to be performed as of the end of the most recent fiscal year, the failure to correct for a known error in this disclosure would likely be considered a material

omission in the registrant's disclosure that would make the disclosure misleading. This conclusion is consistent with the conclusion reached above which requires management to reassess disclosure controls and procedures in connection with the 10-K/A filing even though S-K Item 307 only requires an evaluation as of end of the period covered by the report. Further this is also consistent with the registrant's requirement to file a new 302 certification with the 10-K/A.

View B – No. The rules only require the registrant to make an assessment as of the end of the registrant's most recent year end for Item 308(a).

Committee view: The committee supports View A.

Staff Response: The SEC staff stated that SEC rules require only one assessment by the registrant as of the registrant's most recent year end (i.e. View B). There is no requirement for a registrant to reassess its previous conclusion regarding the effectiveness of internal control over financial reporting (although the Staff did state that registrants are required to update its disclosure if needed to comply with Exchange Act Rule 12b-20.) Any subsequent identification of a material weakness in its internal control over financial reporting would require the registrant to make transparent and specific disclosure of the material weakness under S-K Item 308 in the Form 10-K/A.

A general example of such disclosure in the Form 10-K/A could contain management's original conclusion on internal control over financial reporting (i.e. that its internal control over financial reporting was effective), disclose the subsequent identification of one or more material weaknesses and state that had management been aware of the material weakness at its original assessment date it might have reached a different conclusion.

The Committee observed that such reporting by management in the Form 10-K/A could result in the auditor issuing, in the amended filing, an adverse report on management's assessment of internal controls. The auditor is required to report on both management's assessment of internal controls and on its assessment of internal controls. Under PCAOB Audit Standard No. 2, the auditor is required to consider the need to revise its opinion on internal control over financial reporting when one or more material weaknesses are identified after the issuance of the auditor's report. As such, if management doesn't update their internal control assessment or if management's report in the Form 10-K/A continues to state that internal control over financial reporting was effective at year-end and the auditor concludes, based on subsequent events, that the controls were not effective, then the auditor may be required to issue an adverse report for both the effectiveness of internal control over financial reporting and management's assessment of internal controls over financial reporting in the Form 10-K/A or issue a disclaimer.

PRIOR ATTACHMENT F:

Clarification of PCAOB registration requirements and reports to which Standard No. 1 applies

Background: On May 10, 2004, the Commission approved PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*, and the Standard took effect on May 24, 2004. The Standard requires an auditor, in connection with any engagement performed in accordance with the auditing and related professional practice standards of the PCAOB, to refer to standards of the PCAOB, rather than GAAS, in his/her report.

Question: Should audit reports filed with the Commission on the financial statements of entities that are not issuers reflect the revised report wording, and are independent public accounting firms issuing such reports required to be registered with the PCAOB?

Discussion: The discussion in Section II.C. of Release 34-49528 indicates that the Standard applies to audits of issuers.¹ It states (underlining added) "the PCAOB has adopted ... PCAOB Rule 3100, which requires registered public accounting firms to comply with all applicable auditing and related professional practice standards of the PCAOB in connection with the preparation and issuance of audit reports on the financial statements of issuers. Accordingly, audit reports on the financial statements of issuers must now comply with - and under Auditing Standard No. 1 auditors must state that they performed the audit in accordance with - the standards of the PCAOB."

Commission rules may require or permit the filing of audit reports on a number of entities that are not issuers. Examples include:

- Consolidated subsidiaries²
- Equity method investees
- Collateral entities
- Predecessors
- Targets
- Acquired Businesses

Staff Response: The following schedule outlines the staff's views regarding these questions:

¹ PCAOB Rule 1001 states, "The term 'issuer' means an issuer (as defined in Section 3 of the Exchange Act), the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d) of that Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn." That definition of 'issuer' is also provided in Section 2(a)(7) of the Sarbanes-Oxley Act of 2002.

² PCAOB Release No. 2003-025 comments on audit reports on financial statements of subsidiaries issued by auditors other than the principal auditor. It states that regardless of whether the principal auditor refers to the work of the other auditor, both auditors must comply with the standards of the PCAOB. See also SEC Release No. 34-49708.

	General Guidelines	Auditor’s report on financial statements in current filing must be issued by a public accounting firm registered with the PCAOB?(1)	Auditor’s report on financial statements must refer to PCAOB standards? (2)
1	Issuer (3)	Yes	Yes
2	Entity that has filed a registration statement in an IPO	No (4)	Yes
3	Non-issuer subsidiary, division, or segment of issuer for which other auditor’s report is included in SEC filing due to reference by principal auditor to other auditors(s)	(5)	Yes (6)
4	Non-issuer entity whose financial statements are filed to satisfy S-X Rule 3-05 or 3-14	No	No
5	Non-issuer entity whose financial statements are included in proxy or Form S-4/F-4 as target	No	No
6	Non-issuer entity whose financial statements are filed to satisfy S-X Rule 3-09 or 3-16		
a)	■ No reference to other auditor’s report by issuer’s auditor	(5)	No (7)
b)	■ Reference to other auditor’s report by issuer’s auditor	(5)	Yes (6)
7	Subsidiary–guarantor whose separate financial statements are filed to satisfy S-X Rule 3-10	Yes (8)	Yes
8	Employee benefit plan filing Form 11-K	Yes (8)	Yes

(1) – This guidance is applicable to audit reports issued or dual dated with latest date after 10/21/03 (or 7/18/04 for foreign auditors).

(2) – This guidance is applicable to audit reports issued or reissued on or after May 24, 2004.

(3) – The term ‘issuer’ means an issuer (as defined in Section 3 of the Exchange Act), the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d) of that Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933. See Section 2(a)(7) of the Sarbanes Oxley Act and PCAOB Rule 1001.

(4) –The financial statements that are filed with an initial registration statement need not be audited by a registered firm. Once the company has filed a registration statement, however, it is an “issuer” and any subsequent or restated financial statements must be audited by a registered firm.

(5) – The auditor of the financial statements of the non-issuer entity must be registered if, in performing the audit, the auditor played a “substantial role” in the audit of the issuer, as that term is defined in PCAOB Rule 1001(p)(ii). If the “substantial role” test is not met, the firm is not required to be registered.

(6) - Rule 2-02 of Regulation S-X requires that the auditor’s report state whether the audit was conducted in accordance with GAAS. In Release No. 34-49708, the SEC stated that “references in Commission rules...to GAAS or to specific standards under GAAS, *as they relate to issuers*, should be understood to mean the standards of the PCAOB plus any applicable rules of the Commission” (emphasis added). In the situation identified in the chart above, the view of the SEC staff is that the reference to GAAS in Rule 2-02, as applied to the other auditor’s report, does “relate to an issuer” for purposes of Release No. 34-49708 and that, therefore, the other auditor’s report must refer to the standards of the PCAOB.

(7) – Even though the other auditor’s report is not required to refer to the standards of the PCAOB, if the issuer’s auditor uses the work of the other auditor, that audit work must be performed in accordance with the standards of the PCAOB.

(8) – The entity is itself an issuer and so must comply with issuer rules.

Committee Interpretive Examples: The Committee also seeks the Staff’s view on the following interpretative examples:

Example 1 – Unregistered Auditors and Financial Statements Updated for Additional Interim Period

Company files an IPO registration statement that includes audited financial statements for the three years ended December 31, 2004 and unaudited interim period financial statements for the six months ended June 30, 2005 (with comparative prior year period).

The financial statements are audited by an unregistered independent accounting firm whose report is included in the registration statement.

Company files Amendment 1 to the registration statement in November 2005 that includes audited financial statements for the three years ended December 31, 2004 with no changes from the financial statements originally filed. The interim financial statements are updated to include unaudited financial statements for the nine months ended September 30, 2005 (with comparative prior year period). Company expects Amendment 1 to be declared effective.

The auditors’ report from an unregistered firm continues to be acceptable in Amendment 1 and upon effectiveness.

In subsequent Exchange Act filings and new registration statements it is acceptable to carry forward the report of the unregistered auditors for years ended before 2005.* The audit for 2005 must be performed by a registered firm.

Staff Response: The staff concurred with the above example.

Example 2 – Unregistered Auditors and Financial Statements Updated for Annual Period

Company files an IPO registration statement that includes audited financial statements for the three years ended December 31, 2004 and unaudited interim period financial statements for the nine months ended September 30, 2005 (with comparative prior year period). The financial statements are audited by an unregistered independent accounting firm whose report is included in the registration statement.

Company files Amendment 1 to the registration statement in March 2006 that includes audited financial statements for the three years ended December 31, 2005 (i.e., a new year of audited financial statements is filed). No changes are made to the financial statements for the two years ended December 31, 2004. Company expects Amendment 1 to be declared effective.

In Amendment 1 and upon effectiveness the auditors' report from an unregistered firm continues to be acceptable covering the two years ended December 31, 2004* but the year ended December 31, 2005 will require audit by a registered independent accounting firm.

In subsequent Exchange Act filings and new registration statements it is acceptable to carry forward the report of the unregistered auditors for years ended before 2005.

Staff Response: The staff concurred with the above example.

Example 3 – Unregistered Auditors and Financial Statements Restated for Error Correction

Company files an IPO registration statement that includes audited financial statements for the three years ended December 31, 2004 and unaudited interim period financial statements for the six months ended June 30, 2005 (with comparative prior year period).

The financial statements are audited by an unregistered independent accounting firm whose report is included in the registration statement.

Company files Amendment 1 to the registration statement in November 2005 that includes audited financial statements for the three years ended December 31, 2004. The financial statements for only the year ended December 31, 2004 is restated for a material error correction. The interim financial statements are updated to include unaudited

financial statements for the nine months ended September 30, 2005 (with comparative prior year period). Company expects Amendment 1 to be declared effective. In Amendment 1 and upon effectiveness an auditors' report from an unregistered firm continues to be acceptable covering the two years ended December 31, 2003 but the year ended December 31, 2004 requires audit by a registered independent accounting firm.

In subsequent Exchange Act filings and new registration statements it is acceptable to carry forward the report of the unregistered auditors for years ended before 2004.* The audits for 2004 and 2005 must be performed by a registered firm.

Staff Response: The staff concurred with the above example.

Example 4 – Unregistered Auditors and Financial Statements Revised for Immaterial Changes

Company files an IPO registration statement that includes audited financial statements for the three years ended December 31, 2004 and unaudited interim period financial statements for the six months ended June 30, 2005 (with comparative prior year period). The financial statements are audited by an unregistered independent accounting firm whose report is included in the registration statement.

Company files Amendment 1 to the registration statement in November 2005 that includes audited financial statements for the three years ended December 31, 2004. The financial statements for the two years ended December 31, 2003 are revised for a minor reclassification among income statement line items for which there will be no reference in the auditors' report. The financial statements for the year ended December 31, 2004 do not change. The interim financial statements are updated to include unaudited financial statements for the nine months ended September 30, 2005 (with comparative prior year period). Company expects Amendment 1 to be declared effective.

The auditors' report from an unregistered firm continues to be acceptable in Amendment 1 and upon effectiveness.(*)

In subsequent Exchange Act filings and new registration statements it is acceptable to carry forward the report of the unregistered auditors for years ended before 2005.* The audit for 2005 must be performed by a registered firm.

(*) The unregistered auditors' reports will continue to be accepted in future filings unless the years covered by those reports require revision to financial statements for restatements, either as a result of error correction or application of GAAP that requires retroactive revision (e.g., discontinued operations, change in segments, accounting changes, etc.).

Staff Response: The staff concurred with the above example.