

# A Guide for Foreign Private Issuers



## US GAAP Controls and Procedures\*

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# Introduction

This brief guide aims to help Foreign Private Issuers (“FPIs”) consider the appropriate controls over the preparation of the US GAAP information disclosed in their financial statements.

Section 404 of the Sarbanes-Oxley Act of 2002 requires those FPIs filing annual reports on foreign forms (Form 20-F and Form 40-F) that are accelerated filers to assess the effectiveness of their internal control over financial reporting as of their year-ends, beginning with years ending on or after 15 July 2006. For non-accelerated filers, the requirement currently becomes applicable with years ending on or after 15 July 2007. For FPIs, Section 404 encompasses the financial statements within the annual US filing, including the accompanying notes.

For FPIs, the challenges presented by Section 404 are in many respects very similar to those large US companies have faced since 2004. This guide is not intended to replicate existing guidance on implementing Section 404. But one important aspect of the overall challenge that has not been relevant for US registrants is that most foreign private issuers present financial information under two different bases of accounting: first, either International Financial Reporting Standards, or the accounting standards of their home country, as their primary financial statements (“base GAAP”); and second, certain information required by US GAAP and Regulation S-X (“US GAAP”). This incremental information is most frequently presented in the notes to the financial statements in the form of reconciliation from base GAAP to US GAAP.

# Overarching Principles of Section 404 Relating to the US GAAP Information

Before turning to more specific controls and procedures relating to the US GAAP information, let's consider some overarching principles related to Section 404.

## Recognised Framework

To assess the effectiveness of internal control over financial reporting, management must use a recognised framework. In our experience, the only framework typically used in the US and globally is *Internal Control - Integrated Framework* published by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. The COSO report describes five components of internal control over financial reporting: Control Environment, Risk Assessment, Control Activities, Information and Communication and Monitoring.

The external auditor is required to perform the audit of internal control over financial reporting in accordance with Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (AS 2), adopted by the Public Company Accounting Oversight Board (United States) (PCAOB) in March 2004.

## Material Weakness: Ineffective Internal Control Over Financial Reporting

The final SEC rules implementing Section 404 don't permit the conclusion that a company's internal control over financial reporting is effective if management identifies one or more material weaknesses. A material weakness is a control deficiency, or a combination of control deficiencies, that results in more than a remote likelihood that a *material* misstatement in the financial statements or disclosures, including the US GAAP reconciliation, will not be prevented or detected. Accordingly, a material weakness in controls over the preparation of US GAAP information will require management, and the external auditor, to conclude that a company's overall internal control over financial reporting is ineffective.

## Point-in-time Concept

Section 404 requires management to assess internal control over financial reporting as of a point in time: the current year-end balance sheet date. To conclude internal control over financial reporting is effective as of a point in time, management must be satisfied that a material weakness does not exist as of year-end.

The point-in-time concept allows management to implement changes to the company's controls in order to address control deficiencies identified prior to year-end and still conclude that internal control over financial reporting is effective as of year-end – *if* such corrected or remediated controls are designed and in place for a sufficient period of time prior to year-end.

## Responsibilities of Management and External Auditors

Discussion between management and auditors of the appropriate accounting and controls for US GAAP information is a normal and expected element of achieving appropriate public reporting. However, the distinction in the parties' responsibilities should be clearly understood.

Management of an FPI is responsible for preparing the financial statements, including the US GAAP information. Management is also responsible for assessing internal control over financial reporting, including controls that relate to the US GAAP information. Guidance for this assessment is included in the SEC's final rules on Section 404, issued in June 2003, and in a series of Frequently Asked Questions subsequently issued by SEC staff.

External auditors are responsible for expressing opinions on the financial statements, on management's assessment of whether effective internal control over financial reporting was maintained, and on the effectiveness of internal control over financial reporting.

The PCAOB has identified a common misconception resulting from AS 2 – the idea that companies may no longer look to their auditors for advice on difficult accounting and internal control issues. But nothing in AS 2 imposes any such requirement. The PCAOB stated, "Determining when it is appropriate for the auditor to provide accounting advice requires professional judgment and common sense. Auditors may not, of course, make accounting decisions for their clients, and management may not abandon its responsibility for quality financial reporting and simply rely on auditors to catch errors. Where management makes its own informed decisions regarding how applicable accounting principles apply to its company's circumstances, however, the auditor may discuss freely with management the meaning and significance of those principles."

To help dispel confusion on this issue, PCAOB staff has addressed the question of whether audit clients may – or should – share draft financial statements with their auditors. The answer is decidedly "yes." The PCAOB stated, "Indeed, information-sharing on a timely basis between management and the auditor is necessary. When reviewing draft financial statements, in determining the point at which the auditor must draw the line for purposes of identifying when a deficiency exists, the auditor should be concerned primarily about instances in which the company completed its financial statements and disclosures without recognizing a potential material misstatement. If it is clear that all applicable controls have not yet operated, then a conclusion as to whether a material misstatement in draft financial statements demonstrates a control deficiency would be premature."

Auditors may also provide audit clients technical advice on the proper application of GAAP, including offering suggestions to improve disclosures related to the US GAAP information. In addition, management may discuss with the auditor preliminary drafts of

accounting research memos, spreadsheets, and other working papers in order to obtain the auditor's views on the assumptions and methods management selected. Although it may be helpful for some of these communications to be made in writing, timely and open communication is often best accomplished in person.

## Strong Indicators of a Material Weakness

AS 2 describes certain circumstances that should be regarded as at least a significant deficiency and as a strong indicator of a material weakness in internal control over financial reporting. The two circumstances most relevant to the evaluation of controls over US GAAP information are (1) restatement of previously issued financial statements to reflect the correction of a misstatement; and (2) the identification by the auditor of a material misstatement in the current- period financial statements, including the accompanying notes to the financial statements, that was not initially identified by the company's internal control over financial reporting.

Restatement of previously issued financial statements to reflect the correction of a misstatement is at least a significant deficiency and a strong indicator of a material weakness. The correction of a misstatement includes misstatements due to error or fraud; it does not include restatements to reflect a change to comply with a new accounting principle, or a voluntary change from one generally accepted accounting principle to another. Restatement of US GAAP information by FPIs has not been infrequent.

The auditor's identification of a material misstatement of the US GAAP information would be considered at least a significant deficiency and a strong indicator of a material weakness. This is so, even if management subsequently corrects the misstatement, or has designed and put in place, *after* year-end, what it believes are effective controls over the preparation of US GAAP information. Because such a finding of material misstatement typically occurs after year-end, there is no opportunity for management to correct or remediate the deficient control *before* year-end – ordinarily resulting in the conclusion that internal control over financial reporting was ineffective as of the year-end date.

We expect that the introduction of 404 will prompt many FPIs to improve controls and procedures relating to the US GAAP information. This guide is designed to encourage and support such improvements.

## Application of Internal Controls to the US GAAP Information

Control can be applied to the process of preparing US GAAP information in several ways. The guidance that follows indicates the types of controls we believe can be applied by FPIs, grouping them in the following categories: (1) tone at the top, (2) review and monitoring, (3) people – their knowledge and experience, (4) group-wide coverage, and (5) record keeping. The simple diagram below suggests a way to view the relationship among these categories of control, emphasizing the encompassing nature of higher-level controls.

## Base Elements of Control



Before considering good practices in each of these areas, it is important to note that the complexity of reconciling base GAAP financial statements to US GAAP can vary substantially among FPIs for many different reasons. For some FPIs these risks should already be reasonably well understood by management, and should guide the design of appropriate controls and procedures.

Examples of situations that may increase the risk of misstatement of US GAAP information include complex transactions, group acquisitions or disposals, new accounting standards, challenging communication issues and management changes at particular operations.

When addressing the question “*How much control over the US GAAP reconciliation process is sufficient for internal control over financial reporting to be effective?*” an appropriate answer is “*it depends.*” What it depends on is largely driven by risk of material misstatement of the US GAAP information. What follows is not a checklist, nor a guide to achieving either minimum standards or “gold-plated compliance.” An FPI’s management will need to consider the sufficiency of controls over the US GAAP information in each company’s particular circumstances. However, all FPIs must adequately document and obtain sufficient evidence about the effectiveness of the specific processes, procedures and controls used in the preparation, review and reporting of the US GAAP reconciliation.

## **1. Tone at the top**

The effectiveness of the US GAAP process and controls can be greatly affected by the overall control environment, in respect of both accounting information generally and US GAAP reporting specifically.

The commitment of governance bodies such as the board and audit committee, as well as senior management, to the importance, accuracy and transparency of US GAAP reporting and the relevant controls is an important element of the overall control environment. This commitment can be assessed by considering the people, processes and budget made available to address US GAAP reporting, and also the thoroughness of the top-level review of the draft US GAAP information. Any impression that the governance bodies or senior management are indifferent to US GAAP would, manifestly, communicate the wrong tone at the top.

## **2. Review and monitoring**

We recommend that procedures be in place to ensure that management with requisite US GAAP knowledge review and monitor the US GAAP reporting process. Such review would require appropriate training and updating of technical knowledge. We suggest that formal review and approval of the US GAAP information take place at a supervisory level, perhaps performed by the group financial controller or equivalent. Review and approval procedures could usefully cover:

- the draft disclosures in the US filing, such as the US GAAP reconciliation and supporting footnotes. Particular focus should be given to the comparison of reconciling items in prior years to the drafted reconciling items for the current year;
- all US GAAP adjustments, journal entries and supporting documentation;
- the equity rollforward reconciliation and any other movement analyses or summary primary statements;
- the reconciliation of effective to statutory income tax rates on a US GAAP basis; and
- the US GAAP disclosure checklist.

It's important that management define and document the procedures of the review. For example, what will be the level of review and follow-up of the US GAAP disclosure checklist? Will the reviewer only consider exceptions noted by the checklist preparer, or will he or she independently complete selected sections of the checklist for higher-risk disclosure items? Further guidance on the preparation of these accounting records can be found at item 5 below.

Clear responsibility should be assigned for assessing the adequacy of the design and operation of controls relating to US GAAP information. We recommend that formal sign-off of this evaluation be at an appropriate level below that of the chief financial officer.

The chief executive officer and chief financial officer must both report publicly on the overall internal control over financial reporting. The procedures they adopt to discharge this responsibility should be determined with due regard for the US GAAP information.

### **3. People –their knowledge and experience**

An FPI's ability to identify and quantify US GAAP adjustments and then produce appropriate disclosures depends on having people with requisite knowledge and experience to administer and monitor US GAAP reporting. Key attributes of these people include:

- *level of experience* – individuals involved should be capable of researching and drafting an initial position paper on US GAAP accounting issues relevant to the organisation;
- *qualification* – a US CPA qualification is not a necessary condition, but may be a helpful indicator of capability;
- *training* – relevant people should be able to show how they have achieved and maintained their knowledge of US GAAP to achieve their capability; and
- *access to technical resources* – individuals involved in the US GAAP process should have ready access to the rules and regulations, including timely updates of new standards and developments; and should be able to consult with the external auditor or other technical resources.

The number and location of the individuals with US GAAP credentials is a matter for careful consideration. We would expect the need for knowledge of US GAAP to increase where there is greater risk owing to complexity of accounting or geographic diversity. Effective monitoring and review of the US GAAP accounting process is very difficult to achieve if there is only one individual at an FPI with relevant capability.

We recommend that as part of the 404 documentation process, FPIs inventory the relevant knowledge and experience of those responsible for the preparation and review of US GAAP information. This inventory can then be considered as part of the overall assessment of US GAAP controls and procedures.

Some FPIs choose to supplement the US GAAP expertise of their staff with third parties such as short-term contractors or professional services firms. This can help with the preparation of US GAAP information – particularly in complex areas of US accounting – and can facilitate management's review. Where relevant, the expertise and activities of third parties working under the direction of management should be factored into the overall assessment of the US GAAP controls and procedures. In this regard, the knowledge and experience of the individuals performing the work should be evaluated as if they were part of management.

### **4. Group-wide coverage**

An important element of the US GAAP process is the ability to identify and address accounting issues that could give rise to significant US GAAP differences, wherever they arise within the organisation. This is particularly challenging for large groups or groups with multinational or multi-industry operations.

Management should put in place people, processes and controls intended to highlight and report US GAAP issues wherever they arise within the group. We recommend concurrent consideration of both base GAAP and US GAAP aspects of unusual accounting transactions or decisions arising throughout the group.

FPI groups with a more centralised primary reporting process would not normally be expected to have personnel with a deep understanding of US GAAP at each reporting operation. Usually, appropriate control can be achieved by a combination of deep central expertise that takes a proactive approach to identifying US GAAP differences; formal processes for communicating unusual accounting transactions to a central person or team; clearly demarcated ownership and sign-off responsibilities; and suitable group-wide training on issue identification, quantification and US GAAP record keeping.

Conversely, FPI groups with a decentralised primary reporting process need to consider whether their US GAAP expertise at the reporting operations is sufficient.

## **5. Record keeping**

Once accounting and reporting issues have been identified, US GAAP adjustments and disclosures must be properly measured and reflected in the books and records of the company.

Whether double-entry bookkeeping is necessary to an effective control system for US GAAP information depends on one's definition of double-entry bookkeeping. While we don't believe it is essential that FPIs integrate US GAAP reporting into their full general ledger closing process – albeit doing so could be an effective way of maintaining the US GAAP records – we do consider some form of double entry record keeping necessary to ensure that the US GAAP adjustments are properly reflected. For example, companies should avoid simply posting one-sided adjustments to a schedule reconciling net income or equity from base GAAP to US GAAP.

The use of spreadsheets to produce US GAAP financial records at FPIs is commonplace and can be part of a well-controlled process if there is appropriate consideration of the controls and disciplines over the use of important relevant spreadsheet. For instance, matters relating to security, change control and accuracy of formulae used in the spreadsheet should be addressed. If this approach is taken, some of the schedules and analyses that should be prepared include, but are not limited to:

- spreadsheets used in a double-entry format that provides for the production of self-balancing US GAAP information – i.e., the spreadsheets reflect both debits and credits for each adjustment;
- individual journal entries and supporting working papers where appropriate, maintained to record the US GAAP adjustments – with consideration given to the entity to which the adjustment relates for purposes of determining the impact on translation adjustments, minority interest, and income taxes;
- a statement of changes in shareholders' equity using US GAAP balances, with separate identification of each individual item recorded directly to equity and the income statement, this US GAAP statement to be reconciled to the statement of changes using base GAAP; and
- a reconciliation of each balance sheet adjusting item from the beginning to the end of the year, separately distinguishing between items recorded in the income statement and those recorded directly in equity.

Management, with the advice of their advisors and auditors as needed, should determine what other schedules and analyses should be prepared to help ensure that the proper adjustments have been made.

It's necessary to consider the income tax effect of identified US GAAP adjustments – preferably concurrently with consideration of the underlying adjustment. It can be useful to prepare a US GAAP-based reconciliation of the effective tax rate to the statutory rate and review it for reasonableness.

The objective of the record keeping should be to produce an accurate US GAAP reconciliation. A useful discipline would be to prepare a full US GAAP balance sheet and income statement.

The wide extent of necessary disclosures associated with an FPI's annual filing and the frequency of change in US disclosure requirements call for considerable rigour every year. Management should complete a US GAAP disclosure checklist and it's important that this be done by one or more knowledgeable persons. An experienced supervisor should review the completed checklist.

# Conclusion

FPIs confront many of the same challenges as US domestic registrants in implementing Section 404. Controls over the reconciliation of the base GAAP financial information to the US GAAP information are a salient aspect of the overall challenge they face. We believe this guide contains useful information to help management consider appropriate internal controls over the US GAAP information.

Ultimately it is management's responsibility to prepare the financial statements and initially assess the internal control over financial reporting, including the US GAAP information. But it's important for management to know that there is help available. For more information, contact your company's PricewaterhouseCoopers engagement partner. Our extensive FPI-specific experience can be a powerful resource.