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## SEC FLASH REPORT

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### **SEC Publishes Its Concept Release as a Prelude to Issuing Guidance to Management on the Evaluation of the Effectiveness of Internal Control Over Financial Reporting**

**July 12, 2006**

During the week following its May 10 roundtable discussion on the second year experiences with the internal control reporting and attestation provisions related to the requirements for public companies as outlined in The Sarbanes-Oxley Act of 2002 (SOA), the Securities and Exchange Commission (SEC) announced its plan for taking action to improve the implementation of the Section 404 internal control requirements of the Act. The actions the Commission announced included issuance of guidance to management of public companies to assist them in conducting their assessments of the effectiveness of internal control over financial reporting (ICFR).

The Commission's planned actions for issuing guidance to management included two preparatory steps:

- (a) First, the Commission indicated it would issue a Concept Release to provide an opportunity for public comment on issues that might be pertinent to framing its guidance for management.
- (b) Second, the Commission indicated that it would consider additional input from the Committee of Sponsoring Organizations of the Treadway Commission (COSO) as it develops guidance on the application of the 1992 *Internal Control – Integrated Framework* to smaller public companies.

Following these two preparatory steps, the Commission planned to issue formal guidance for management in assessing a company's ICFR with the objective of improving the implementation of the internal control evaluation and reporting provisions of SOA. This is the roadmap the SEC outlined following the May 10 roundtable.

Yesterday, the SEC published a Concept Release as a prelude to its forthcoming management guidance. In addition, COSO issued its guidance on the application of the *Internal Control – Integrated Framework* to smaller companies. This Flash

Report summarizes the purpose and focus of the Concept Release. A separate Flash Report provides an overview of the latest guidance issued by COSO.

### **The Purpose of the Concept Release**

Through the Concept Release, the SEC seeks to understand better the extent and nature of public interest in the development of additional guidance for management regarding the company's evaluation and assessment of ICFR. This understanding is intended to assist the Commission in developing guidance which addresses the needs and concerns of public companies, consistent with the protection of investors.

### **The Focus of the Concept Release**

In its Concept Release, the SEC made the following observations which provide insight as to the overall direction of any guidance it ultimately issues:

- There is no "one-size-fits-all" approach to the evaluation of ICFR. It is not only impractical to develop such an approach, it is inappropriate to do so because methods vary from company to company. The SEC expects the management of each company to bring to bear its own experience and judgment in designing an assessment process for documenting, evaluating and testing controls that is responsive to its operations, risks and processes. The message: Anyone expecting the SEC to issue a "cookbook approach" is going to be disappointed
- The SEC reiterated its sensitivity to the fact that many companies have already invested substantial resources in establishing and documenting their approach to evaluating ICFR. Furthermore, the assessment process for many accelerated filers has been honed over a two-year period under the scrutiny of their independent auditors.
- The decision to issue guidance is a response to the cumulative feedback since the adoption of the Section 404 rules. Many have observed that further clarification is needed as to what constitutes a sufficient effort in the assessment process. Notwithstanding last year's May 16, 2005, guidance issued by the Commission, the management assessment process largely remains auditor-directed for many issuers. Managers of many companies continue to believe they need more guidance regarding when companies have "complied" in achieving "reasonable assurance" regarding (a) the reliability of financial reporting and (b) the adequacy of the body of evidence supporting management's assertion in the annual internal control report. Absent such guidance, companies continue to be effectively subject to standards written for the auditors and to their auditor's interpretation of those standards. This is an issue the SEC intends to rectify.
- When the SEC issued its Section 404 rules, it emphasized two broad principles: (1) management's assessment scope and process must be sufficient

to address both the design effectiveness and operating effectiveness of ICFR and (2) management's assessment, including testing, must be supported by reasonable evidential matter. The Commission notes in the Concept Release that it will hold to these principles.

- Any guidance the SEC issues is not intended to replace or modify the COSO *Internal Control – Integrated Framework* or any other "suitable framework," as defined by the original Section 404 rule. In the Concept Release, the Commission distinguishes between (a) the COSO framework and (b) guidance issued to illustrate how to conduct an assessment of ICFR. The COSO framework focuses more on the "what" and the "why" of internal control and provides criteria for evaluating effectiveness. The COSO framework is not granular enough to illustrate "how" an evaluation is accomplished.

The Commission anticipates that the forthcoming management guidance will cover at least the following four areas which are germane to an evaluation of the effectiveness of ICFR:

- (1) **Risks and Controls** – Identifying risks to financial statement account and disclosure reliability and the related internal controls that address those risks, including how management might use company-level controls to address those risks
- (2) **Evaluation Approach** – Objectives of the alternative evaluation methods and approaches available to gather the body of evidence supporting management's assessment of the effectiveness of ICFR
- (3) **Evaluation Scope** – Factors management should consider to determine the nature, timing, and extent of its evaluation procedures, including the implementation of a so-called "top-down, risk-based" approach to evaluating the effectiveness of ICFR
- (4) **Evaluation Documentation** – Documentation requirements, including overall objectives of the documentation and the factors that might influence documentation requirements

The Concept Release summarizes 35 questions to which the Commission seeks input and feedback. These questions address the above topics and also inquire as to whether guidance should be provided to address other topics.

In the SEC's July 11, 2006, press release announcing the issuance of the Concept Release, SEC Chairman Christopher Cox states that the SEC's goal is "to develop practical guidance for companies to help improve the reliability of financial reporting and to make Section 404 implementation more efficient and cost effective for investors." Chairman Cox also noted, "The public comment we receive in response to [the] Concept Release will help the SEC write meaningful

guidance for all public companies – large, small, foreign, and domestic – for the benefit of all of their shareholders."

### **Comment Period and Next Steps**

In summary, the Commission seeks useful and broad-based public comment to facilitate its efforts to improve the implementation of Section 404 for issuers and investors alike. In the SEC's press release, SEC Acting Chief Accountant Scott Taub said, "The guidance we issue should help companies further improve and streamline their processes for assessing the effectiveness of internal controls. We intend for the guidance to be flexible and scalable, such that it will assist companies of all sizes."

For a copy of the SEC's press release and Concept Release, interested parties may refer to <http://www.sec.gov/news/press/2006/2006-112.htm>. As noted above, the Concept Release lists out the 35 questions to provide a context for interested parties in submitting input and feedback to the SEC. Comments must be submitted within 60 days after the Concept Release is published in the Federal Register, i.e., the comments will be due around the middle of September. In accordance with the usual practice, comment letters will be posted "as is" to the SEC website. The SEC invites commenters to raise any additional issues or concerns not specifically addressed by the 35 questions. In addition, the SEC invites commenters to submit descriptions of, or actual process plans, that their companies have implemented for portions or all of management's assessment process.

Regarding next steps, the SEC did not articulate its process or timetable. One likely scenario is that the Commission will take into consideration the feedback received and formulate proposed guidance. The proposed guidance would then be issued for public comment for a period ranging from 30 to 45 days. Following the public comment period, the SEC will issue its guidance in final form. While the timing of the proposed guidance is speculative at this time, it is clear the SEC has this project on the "fast track." It is not unreasonable to expect the Commission to have a timetable for issuing its final guidance in time for management of calendar-year reporting companies to consider it in conjunction with planning 2007 ICFR assessments. To meet this timetable, the proposed guidance would probably be issued in the fall of this year.