

## SEC FLASH REPORT

### **SEC Proposes Interpretive Guidance on Management's Internal Control Evaluation and a Change to the Auditor Attestation**

**December 13, 2006**

During an open meeting today, the Securities and Exchange Commission (SEC) voted unanimously to take the following actions to improve the cost-effectiveness of the implementation of Section 404 of the Sarbanes-Oxley Act (SOA):

- Propose interpretive guidance to assist management in planning and performing its annual evaluation of internal control over financial reporting (ICFR).
- Propose amendments to its rules that would make it clear that a company choosing to perform an evaluation of ICFR in accordance with the interpretive guidance would satisfy the annual evaluation required by those rules.
- Propose changes to its requirements for attestation reports to require only an auditor opinion on ICFR.

With respect to the SEC's actions this week, Protiviti is issuing two Flash Reports – one today to outline briefly the Commission's actions today and a second one which articulates further commentary based on the proposed guidance and rule amendments once they are posted on the SEC's website. The Commission's press release summarizing its proposals related to Section 404 is available at: <http://www.sec.gov/news/press/2006/2006-206.htm>.

The SEC did not address today its pending proposals with respect to initial implementation of Section 404 by non-accelerated filers and IPO companies. Because many parties continue to inquire on these issues, we expect the Commission to finalize these proposals relatively soon.

Interested parties will be given an opportunity to comment on the proposed interpretive guidance and rule amendments. The comment period expires 60 days after the proposed guidance and rule amendments are published in the Federal Register. Today's proposals are discussed further below.

### **The Proposed Interpretive Guidance**

In the past, there has been limited authoritative guidance regarding management's evaluation of ICFR. Absent such guidance, companies were effectively subject to standards written for the auditors and to the auditor's interpretations of those standards. Without a tool, management was unable to effectively gauge the effort and control the related costs. Once the proposed interpretive guidance goes into effect, companies will be able to use the SEC's guidance, and need not use the guidance issued to auditors by the Public Company Accounting Oversight Board (PCAOB), as the authority for their evaluation approach.

According to SEC Chairman Cox, the purpose of the interpretative guidance is to help management make their evaluation process more cost-effective. In doing so, the Commission staff pointed out during the open meeting that there is a distinction between an insider's assessment of ICFR and an

external auditor's assessment of ICFR, i.e., the two assessments need not apply the same procedures. Management can exercise significant judgment in designing and executing an evaluation of ICFR. The interpretive guidance will state that the auditor and management can and will have different testing approaches and, in such circumstances, both approaches can be effective. With the Commission's proposed guidance, it is intended that "management will be able to scale and tailor their evaluation procedures to fit their facts and circumstances, and investors will benefit from reduced compliance costs."

In commenting on the Concept Release, many accelerated filers and trade associations expressed concern about being sent back to the drawing board by this interpretive guidance after investing heavily in compliance during the first two years of implementing Section 404. Several comments were made during the open meeting with the intent to put this concern to rest. There is flexibility in the interpretive guidance such that companies will be able to continue using their existing compliance process provided it is effective and meets the requirements of Section 404.

The proposed guidance is principles-based and is organized around two important principles:

- (1) Management should evaluate the design of the controls that it has implemented to determine whether there is a reasonable possibility that a material misstatement in the financial statements would not be prevented or detected in a timely manner. This principle promotes efficiency by allowing management to focus on those controls that are needed to prevent or detect material misstatement in the financial statements.
- (2) Management should gather and analyze evidence about the operation of the controls being evaluated based on its assessment of the risk associated with those controls. This principle allows management to align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the greatest risks to reliable financial reporting.

By following these two principles, the SEC is of the view that companies of all sizes and complexities will be able to implement its rules more effectively and efficiently. As smaller public companies often have less complex internal control systems than larger public companies, this proposed approach would enable smaller public companies in particular to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances.

Those parties hoping for detailed guidance are going to be disappointed. The interpretive guidance is not prescriptive. It encourages management to apply judgment based on the unique facts and circumstances. It also provides management flexibility in determining how much documentation is required to support the evaluation. For example, one comment was made during the open meeting that management may determine that a particular risk is addressed by a company-level control or by a few controls within a process. The proposed interpretive guidance states that management is not required to identify and document all controls within a process. The focus is on identifying and documenting only the important controls that really matter.

The proposed guidance describes a risk-based approach that addresses four specific areas:

- Identification of risks to reliable financial reporting and the related controls that management has implemented to address those risks, including the risk of fraud
- Evaluation of the operating effectiveness of controls, with emphasis on a top-down approach

- Reporting the overall results of management's evaluation, including a framework for assessing the severity of control deficiencies
- Documentation, with emphasis on reasonable documentary evidence and on management exercising judgment to tailor the nature and extent of documentation maintained

Once the SEC posts the interpretive guidance on its website, we will issue a second Flash Report commenting on the above areas.

## **The Proposed Rule Amendments**

The Commission proposed amendments to Rules 13a-15 and 15d-15 that would make it clear that a company choosing to perform an evaluation of internal control in accordance with the interpretive guidance would satisfy the annual evaluation required by those rules. The objective of these rule amendments is to make it clear that the authoritative literature for management's evaluation lies with the SEC's interpretive guidance.

## **The Proposed Changes to the Attestation Report**

The Commission also proposed amendments to Regulation S-X to clarify the auditor's reporting requirement pursuant to Section 404(b) of SOA. The feedback the Commission has received is that the auditor's dual opinion is unnecessarily complex and created confusion as to the nature and extent of the procedures required of management. Therefore, today's proposed amendments to Regulation S-X eliminate the auditor's opinion on management's assessment process and are intended to clarify the auditor reporting requirement in a consistent manner with the anticipated revisions to Auditing Standard No. 2.

## **The PCAOB's Forthcoming Revisions Will Complete the Picture**

While the interpretive guidance proposed today is intended to help public companies of all sizes, several comments were made during the open meeting to the effect that smaller companies should particularly benefit from the scalability and flexibility emphasized in the guidance. That said, the proposed interpretive guidance must be viewed along with the revised auditing standard to be proposed next week by the PCAOB. Together, these coordinated actions by the Commission and the Board are intended to result in significant improvements in the implementation of Section 404. Although the SEC's guidance is directed to management and the expected proposal from the PCAOB is directed to auditors, the SEC staff pointed out that respondents should "take advantage of the [two] proposals' overlapping comment periods to consider whether the proposals, if adopted, will ensure an appropriate balance between management's evaluation process and the audit process."