

## SEC FLASH REPORT

### **The SEC's Proposed Interpretive Guidance on Management's Internal Control Evaluation – A Briefing**

**December 26, 2006**

Two weeks ago, the Securities and Exchange Commission (SEC) voted unanimously to take action to improve the cost-effectiveness of the implementation of Section 404 of the Sarbanes-Oxley Act (SOA). One of the Commission's actions was to propose interpretive guidance to assist management in planning and performing its annual evaluation of internal control over financial reporting (ICFR). A prior SEC Flash Report, dated December 13, 2006, highlighted this proposed guidance as well as the SEC's other related proposals. It is presumed that the reader has read this Flash Report. Last week, the Commission published its proposed interpretive guidance, which is available at <http://www.sec.gov/news/whatsnew/wn122006.shtml> under "Proposed Rules." This Flash Report summarizes more specifically that proposed guidance.

The proposed interpretive guidance is intended to enable management to conduct a more effective and efficient evaluation of ICFR. The guidance indicates that management's evaluation process will vary from company to company, because there is no one-size-fits-all approach. However, the SEC's evaluation process is a top-down, risk-based approach which the Commission believes is more efficient and effective than what is generally being applied in practice.

While the proposal release numbers a total of 71 pages, the real meat of the guidance begins on page 13 and ends on page 49. The document is double spaced, so it is not a lengthy read. Managers responsible for Section 404 compliance should read this proposed guidance carefully, because the SEC has written it specifically for them and the companies they represent, and not for auditors. The Public Company Accounting Oversight Board (PCAOB) is issuing separate guidance to auditors, and that guidance is summarized through separate PCAOB Flash Reports.

While this Flash Report provides a briefing on some of the high points of the proposed guidance, it is intended neither as a legal analysis nor as a substitute for reading the proposed guidance in its entirety. Considerable judgment must be exercised when applying the proposed guidance. Companies should seek legal counsel and appropriate risk advisors for advice on specific questions as they relate the proposed interpretive guidance to their unique circumstances.

### **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. 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 PCAOB, as the authority for their approach to evaluate ICFR.

As noted in the SEC Flash Report issued on December 13, 2006, the proposed guidance is principles-based and is organized around two important principles:

<i><b>PRINCIPLE</b></i>	<i><b>SEC COMMENTARY</b></i>
First, 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 is addressed through a top-down, risk-based approach that promotes efficiency by allowing management to focus on those controls that are needed to prevent or detect material misstatement in the financial statements
Second, 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

In the proposed guidance, the SEC asserts that if these two principles are truly followed in practice, then companies of all sizes and complexities will be able to implement its rules more effectively and efficiently through an approach that is top-down, risk-based and scalable. The proposed interpretive guidance addresses the following topics:

A. The Evaluation Process

1. Identifying Financial Reporting Risks and Controls
  - a. Identifying Financial Reporting Risks
  - b. Identifying Controls that Adequately Address Financial Reporting Risks
  - c. Consideration of Entity-level Controls
  - d. Role of General Information Technology Controls
  - e. Evidential Matter to Support the Assessment
2. Evaluating Evidence of the Operating Effectiveness of ICFR
  - a. Determining the Evidence Needed to Support the Assessment
  - b. Implementing Procedures to Evaluate Evidence of the Operation of ICFR
  - c. Evidential Matter to Support the Assessment
3. Multiple Location Considerations

B. Reporting Considerations

1. Evaluation of Control Deficiencies
2. Expression of Assessment of Effectiveness of ICFR by Management and the Registered Public Accounting Firm
3. Disclosures About Material Weaknesses
4. Impact of a Restatement of Previously Issued Financial Statements on Management's Report on ICFR
5. Inability to Assess Certain Aspects of ICFR

In this Flash Report, we have prepared this briefing by selecting specific points made by the SEC on the above topics and organizing these points around four areas – risk and control identification, control evaluation, reporting results and documentation. Then we summarize the SEC’s commentary on special considerations with respect to foreign private issuers. Finally, we provide commentary on the overall implications to all companies of the SEC interpretive guidance.

## Risk and Control Identification

The proposed guidance describes a risk-based approach that would require management to exercise judgment to do two things. First, management would determine those areas that are both material and pose a risk to reliable financial reporting. Second, management then would identify the controls that address those risks, including the risk of material misstatement due to fraud. Through these two evaluations, management identifies both (1) the risks to reliable financial reporting and (2) the related controls that the company has implemented to address those risks. Therefore, risk is pervasive throughout the entire evaluation process and the approaches for gathering evidence to support management’s evaluation must be based on the assessment of risk.

Some key points made by the SEC in its proposed guidance with respect to risk identification:

- Assess risk based on the standard of providing “reasonable assurance” regarding the reliability of financial reporting – “Reasonable assurance” is not “absolute assurance.” The SEC uses the “prudent official” test to define “reasonable assurance” and “reasonable detail.”
- Select financial reporting elements based on risk – According to the proposed guidance, the characteristics of a financial reporting element that management considers include both the materiality of the financial reporting element and the susceptibility of the underlying account balances, transactions or other supporting information to material misstatement. The assessed risk of a financial reporting element generally increases when the given element: (1) involves judgment in determining the recorded amounts; (2) is susceptible to fraud; (3) has complex accounting requirements; or (4) is subject to environmental factors, such as technological and/or economic developments.
- Consider source and likelihood of material misstatements – “Management [should use] its knowledge and understanding of the business [and] the organization, operations, and processes to consider the sources and likelihood of potential misstatements” and identify those risk sources that could result in a material misstatement to the financial statements. Financial reporting risks may arise from sources such as the initiation, authorization, processing and recording of transactions and other adjustments that are reflected in financial reporting elements.
- Focus on the risk of fraud – Misstatements include both errors and omissions, whether inadvertent or intentional. Accordingly, management’s evaluation of financial reporting risks should consider the vulnerability of the entity to fraud, and whether the fraud risk might result in a material misstatement of the financial statements.
- Consider the risk characteristics of multiple controls – The determination of whether an individual control, or a combination of controls, adequately addresses a financial reporting risk involves judgments about both the likelihood and potential magnitude of misstatements.

When a combination of controls is required to adequately address the risks affecting a financial reporting element, the SEC guidance asserts that management should analyze the risk characteristics of each control. In considering the likelihood that a control might fail to operate effectively, the guidance points out that management should consider the “type of control (i.e., manual or automated), the complexity of the control, the risk of management override, the judgment required to operate the control, the nature and materiality of misstatements that the control is intended to prevent or detect, and the degree to which the control relies on the effectiveness of other controls (e.g., general IT controls).”

- Recognize what makes many smaller companies different when identifying risk for them – The manner in which financial reporting risks are identified will vary based on the size, complexity, and organizational structure of the company and its processes and financial reporting environment. For example, in a small company with less complex business processes that operate on a centralized basis and with little change in its risks or processes, management’s daily involvement with the business may provide them with adequate knowledge to appropriately identify financial reporting risks.

These comments included by the SEC in its proposed guidance clearly indicate the notion that the assessment of risk is pervasive throughout the evaluation process.

The proposed interpretive guidance does not require that every control within a process be identified and documented to accomplish the purpose of complying with Section 404. Once management identifies the controls that adequately address the risk of material misstatement in the financial statements, it is unnecessary to include additional controls within management's evaluation. Implicit in identifying the important controls is the need to evaluate the design of the selected controls in terms of their effectiveness in mitigating the identified financial reporting risks. For purposes of the evaluation of ICFR, the controls “are not adequate when their design is such that there is a reasonable possibility that a misstatement in the related financial reporting element that could result in a material misstatement in the financial statements will not be prevented or detected on a timely basis.”

In the proposed guidance, some of the relevant points related to control identification include the following:

- Favor the top-down approach over the bottom-up approach – Management may identify controls for a financial reporting element that are preventive, detective or a combination of both. As noted above, it is not necessary to identify the entire population of controls. Rather, management should identify only those controls that adequately address the risk of material misstatement. To illustrate, if a particular risk is addressed by a company-level control or by a few controls within a process, the proposed 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 gives a specific example detailing how an entity-level control may be designed to adequately address the risk of material misestimate for a particular financial reporting element (interest expense) and further asserts that in this case, management need not identify any additional controls at the transaction level. In fact, it was stated during the SEC’s open meeting that the objective is to influence management to not think in terms of

“levels”, i.e., company-level and transaction-level. The focus is on identifying the key controls.

- Consider the nature of the entity-level controls and how they relate to the financial reporting element – The SEC states that “some entity-level controls are designed to operate at the process, transaction or application level and might adequately prevent or detect on a timely basis misstatements in one or more financial reporting elements.” Other entity-level controls comprise the control environment (e.g., the tone at the top and entity-wide programs such as codes of conduct and fraud prevention) and are only “indirectly related to a financial reporting element and may not, by themselves, be effective at preventing or detecting a misstatement in a financial reporting element.” Therefore, the SEC concludes that “while management ordinarily would consider entity-level controls of this nature when assessing financial reporting risk and evaluating the adequacy of controls, it is unlikely management will identify only this type of control as adequately addressing a financial reporting risk identified for a financial reporting element.”
- Recognize the important role of general information technology controls (GITC) – The security and integrity of automated application controls are dependent on strong GITC. The proposed guidance makes several statements with respect to the importance of GITC:
  - While GITC ordinarily do not directly prevent or detect material misstatements in the financial statements, the proper and consistent operation of automated or IT-dependent controls depends upon effective operation of effectively-designed GITC.
  - Aspects of GITC that are relevant to the evaluation of ICFR will vary depending upon a company’s facts and circumstances. Ordinarily, management should consider whether, and the extent to which, GITC objectives apply to its facts and circumstances.
  - Management only needs to evaluate those GITC that are necessary to adequately address financial reporting risks.
  - When adequate GITC exist and are determined to be operating effectively, management may determine that automated controls are more efficient to evaluate than manual controls.
- Use a risk-based approach with respect to multiple location considerations to determine the nature and extent of procedures to be performed at various locations – The risk-based approach may result in the determination that risks are adequately addressed by controls which operate centrally, or it may determine that management needs to perform assessment procedures at individual locations or business units. The SEC’s proposed guidance on multi-location scoping is based on risk and does not include any reference to minimum coverage requirements. The SEC’s articulation of this area merits a careful read by every company concerned with excess coverage in their current evaluation process.

At the end of the risk and control identification process, management will have identified for testing only those controls that are needed to adequately address the risk of a material misstatement in its financial statements and for which evidence about their operation can be obtained most efficiently. Because the guidance allows management to tailor the approach to the company’s financial reporting risks, management can avoid identifying and documenting controls that are not important to achieving the objectives of ICFR.

## Control Evaluation

Once management has determined the controls within the scope of its evaluation, management would then gather and analyze evidence about the operating effectiveness of those controls. The SEC proposed guidance notes that “a control operates effectively when it is performed in a manner consistent with its design by individuals with the necessary competency and authority.” The proposed guidance provides for a risk-based approach that would require the use of judgment to direct management's evaluation efforts towards those areas that pose greatest risk to reliable financial reporting based on the company's unique facts and circumstances.

The proposed guidance would allow management to support its evaluation in a variety of ways and illustrates how management can consider and utilize its existing daily interaction with its business, self-assessment, and other ongoing monitoring activities to support its evaluation. The evaluation procedures that management uses to gather evidence about the effective operation of ICFR should be tailored to its assessment of ICFR risk.<sup>1</sup> An assessment of ICFR risk considers the impact of entity-level controls, which may influence management's judgments about the risks of failure for particular controls. The SEC's underlying premise is that management varies the nature, timing and extent of the evaluation methods it implements in response to judgments about ICFR risk. Thus the greater the misstatement risk of a financial reporting element and the higher the risk of control failure, the greater the amount of evidence required. Conversely, the lower the misstatement risk of a financial reporting element and the lower the risk of control failure, the lesser the amount of evidence required. So the focus of the evaluation of the required amount of evidence is on the risk of misstatement and the risk of failure, as discussed further below:

- Risk of misstatement – Characteristics of the financial reporting element that management considers include both the materiality of the financial reporting element and the susceptibility of the underlying account balances, transactions or other supporting information to material misstatement. When considering the latter, “elements which (1) involve judgment in determining the recorded amounts, (2) are susceptible to fraud, (3) have complexity in the underlying accounting requirements or (4) are subject to environmental factors such as technological and/or economic developments, would generally be assessed as higher risk.”
- Risk of failure – When considering the likelihood that a control might fail to operate effectively, the proposed guidance points out that management considers, “among other things: the type of control (i.e., manual or automated), the complexity of the control, the risk of management override, the judgment required to operate the control, the nature and materiality of misstatements that the control is designed to prevent or detect, and the degree to which the control relies on the effectiveness of other controls (e.g., general IT controls).”

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<sup>1</sup> The SEC defines “ICFR risk” as the collective combination of the risk characteristics of both the individual financial reporting elements and the related controls

In the proposed guidance, the SEC observes”

Certain financial reporting elements, such as those involving significant accounting estimates<sup>2</sup>, related party transactions, or critical accounting policies<sup>3</sup> generally would be assessed as having higher risk for both the risk of material misstatement to the financial reporting element and the risk of control failure. When the controls related to these financial reporting elements are subject to the risk of management override, involve significant judgment, or are complex, they should generally be assessed as having higher ICFR risk.

The above commentary clearly highlights the importance of focusing on these higher risk areas. The SEC followed the above discussion with the following assertion:

When a combination of controls is required to adequately address the risks of a financial reporting element, management should analyze the risk characteristics of each control...[The reason this analysis is necessary] is because the controls associated with a given financial reporting element may not necessarily share the same risk characteristics.

The example the SEC provides in the proposed guidance to illustrate the above assertion clearly reinforces the view that not all tests of controls carry equal weight.

With respect to the evaluation of controls operating effectiveness, the proposed guidance includes many important points. The basic premise is that management ordinarily focuses its evaluation on those areas of ICFR that pose the highest risk to reliable financial reporting. The evaluation procedures that management uses should be tailored to its risk assessment. Management’s assessment of risk should consider the impact of entity-level controls, such as the relative strengths and weaknesses of the control environment, which may influence management’s judgments about the risks of failure for particular controls. Other points asserted in the proposed guidance include:

- Obtain evidence from direct testing of controls and on-going monitoring activities – The nature, timing and extent of evaluation procedures depend on the assessed ICFR risk. In determining whether the evidence obtained is sufficient, management should consider both the quantity of evidence (e.g., sample size) and the qualitative characteristics of the evidence, including “the nature of the procedures performed, the period of time to which the

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<sup>2</sup> The SEC defines “significant accounting estimates” as “accounting estimates or assumptions where the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and the impact of the estimates and assumptions on financial condition or operating performance is material.”

<sup>3</sup> The SEC defines “critical accounting policies” as “those policies that are most important to the financial statement presentation, and require management’s most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.”

evidence relates, the objectivity of those evaluating the controls, and, in the case of monitoring controls<sup>4</sup>, the extent of validation through direct testing of underlying controls.”

- Use the evaluation of ICFR risk as the basis for determining the methods and procedures to gather evidence about the effective operation of controls – The procedures management uses may be integrated with the daily responsibilities of its employees or implemented specifically for purposes of the ICFR evaluation. Evidence may come from day-to-day activities to manage the operations of the business. Further, monitoring activities, including the use of self-assessment, can provide evidence to support the assessment. For any individual control, different combinations of the nature, timing and extent of evaluation procedures may provide sufficient evidence. The selection of the procedures used should be based on the assessment of the risk of misstatement and the risk of failure, as discussed earlier.
- Consider effects of a strong control environment when evaluating the risk of control failure – The SEC points out that management’s judgment about the likelihood that a control fails to operate effectively may be influenced by a highly effective control environment and thereby impact the evidence evaluated for that control. However, a strong control environment would not eliminate the need for evaluation procedures that consider the effective operation of the control in some manner.
- Adjust the nature of the evidence that is obtained as the assessed risk increases – When ICFR risk is assessed as high, the SEC asserts that management’s evaluation would ordinarily include evidence obtained from direct testing. Further, management’s evaluation would ordinarily consider evidence from a reasonable period of time during the year, including the fiscal year-end. As the assessed risk increases, the SEC directs that management can vary the nature of evidence from on-going monitoring by adjusting the extent of validation through periodic direct testing of the underlying controls and/or adjusting the objectivity of those performing self-assessments.<sup>5</sup> Management can also vary the nature of evidence obtained by adjusting the period of time covered by direct testing.
- Recognize that low risk areas offer considerable flexibility – For lower risk areas, the proposed guidance provides management with significant flexibility in making judgments regarding what constitutes adequate evidence. For example, management may conclude

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<sup>4</sup> The SEC defines “monitoring activities” as “those that assess the quality of internal control performance over time. These activities involve assessing the design and operation of controls on a timely basis and taking necessary corrective actions. The process is accomplished through ongoing monitoring activities, separate evaluations by internal audit or personnel performing similar functions, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory review activities.”

<sup>5</sup> The SEC observes that “self-assessment is a broad term that refers to different types of procedures performed by various parties. It includes an assessment made by the same personnel who are responsible for performing the control. However, self-assessment may also be used to refer to assessments and tests of controls performed by persons who are members of management but are not the same personnel who are responsible for performing the control. In this manner, an assessment may be carried out with varying degrees of objectivity. The sufficiency of the evidence derived from self-assessment depends on how it is implemented and the objectivity of those performing the assessment.”

that evidence from on-going monitoring is sufficient and that no direct testing is required. On-going monitoring includes activities that provide information about the operation of controls and may be obtained, for example, through self-assessment procedures and the analysis of performance measures designed to track the operation of controls.<sup>6</sup>

- Consider management's daily interaction with its controls in a small company environment – Management's daily interaction with its controls may provide it with sufficient knowledge about their operation to evaluate the operation of ICFR, particularly in smaller companies. For example, on-going direct knowledge and direct supervision of control operation may contribute to this knowledge from daily interaction. Management should consider the particular facts and circumstances when determining whether or not its daily interaction with controls provides sufficient evidence for the evaluation.

## Reporting Results

Once the evaluation is completed, management must decide if any identified control deficiencies are material weaknesses. The SEC defines a "material weakness" as "a deficiency, or combination of deficiencies in ICFR such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis by the company's ICFR." To clarify, a "reasonable possibility" of an event exists when the likelihood of the event occurring is either "reasonably possible" or "probable." This definition lays the foundation for management's year-end assessment, which is based on whether the controls will fail to prevent or detect a material misstatement (or omission) on a timely basis. Whether or not a misstatement actually has occurred is not germane to this assessment.

The proposed guidance provides management with a framework, outside of the auditing literature, for making these judgments and includes situations that are considered strong indicators that a material weakness exists. The list of strong indicators provided in the proposed guidance is basically the same one included in the existing Auditing Standard No. 2 (AS2). The list includes:

- An ineffective control environment, e.g., the identification of fraud of any magnitude on the part of senior management, significant deficiencies that have been identified and remain unaddressed after some reasonable period of time, ineffective oversight by the company's audit committee, etc.
- Restatement of financial statements to reflect the correction of a material misstatement; however, such restatements do not include a retrospective application of a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle

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<sup>6</sup> The SEC points out that "management's evaluation process may also consider the results of key performance indicators (KPI's) in which management reconciles operating and financial information with its knowledge of the business. While these KPI's may indicate a potential misstatement in a financial reporting element and therefore are relevant to meeting the objectives of ICFR, they generally do not monitor the effective operation of other controls. The procedures that management implements...should evaluate the effective operation of these KPI type controls when they are identified...as addressing financial reporting risk."

- Identification by the auditor of a material misstatement in the current period under circumstances that indicate the misstatement would not have been discovered by the company's ICFR.
- For complex entities in highly regulated industries, an ineffective regulatory compliance function where the associated violations of laws and regulations could have a material effect on the reliability of financial reporting.

The primary difference between the above list and the existing AS2 list is that the SEC's proposed guidance does not consider any of the above items to be de facto significant deficiencies. The PCAOB is proposing a similar revision in revising AS2.

The SEC's proposed guidance describes the factors that management should consider when evaluating the severity of a deficiency. For example, to determine whether there is a material weakness, the SEC points out that management evaluates each identified control deficiency, considering both quantitative and qualitative factors, and the likelihood and the magnitude of the potential misstatement resulting from the deficiency or deficiencies. According to the proposed guidance, some relevant considerations affecting the likelihood that a deficiency, or a combination of deficiencies, will result in a misstatement include, but are not limited to:

- The nature of the financial statement elements, or components thereof, involved (e.g., suspense accounts and related party transactions involve greater risk)
- The susceptibility of the related asset or liability to loss or fraud
- The subjectivity, complexity, or extent of judgment required to determine the amount involved
- The interaction or relationship of the control with other controls
- The interaction of the deficiencies and the financial statement accounts and assertions they impact
- The possible future consequences of the deficiency

According to the proposed guidance, some relevant factors affecting the magnitude of the misstatement that might result from a deficiency, or a combination of deficiencies, include, but are not limited to:

- The financial statement amounts or total of transactions exposed to the deficiency
- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

Management should evaluate the effect of compensating controls<sup>7</sup> when evaluating whether a deficiency, or a combination of deficiencies, is a material weakness.

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<sup>7</sup> The SEC asserts that "compensating controls are controls that serve to accomplish the objective of another control that did not function properly, helping to reduce risk to an acceptable level. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that was material."

If a deficiency, a combination of deficiencies, is a material weakness, consistent with the Commission's existing rules, management must conclude that ICFR is not effective. In such circumstances, management has reporting responsibilities surrounding the disclosure to investors of that material weakness. This means that management should disclose a clear expression of its assessment related to the effectiveness of ICFR without any qualification of its assessment. If a material weakness exists, management may not state that the company's ICFR is effective except for the area in which there is a material weakness. However, the proposed guidance does allow management to state that controls are ineffective due solely to, and only to the extent of, the identified material weakness(es), as long as management has considered the nature and pervasiveness of the material weakness(es).

Section 404 was intended to bring information about material weaknesses in ICFR into public view. When disclosing a material weakness, the SEC's proposed guidance encourages companies to consider including enough information to allow investors to understand the root cause the deficiency and to assess the potential impact of a material weakness, including (a) the nature of the material weakness, (b) its impact on financial reporting and the control environment and (c) management's current plans, if any, for remediating the weakness.

An important question arises as to the impact of financial restatements on the assertions expressed in prior period management internal control reports. When a material misstatement in previously issued financial statements is discovered, a company is required to restate those financial statements. The proposed guidance states that "while there is no requirement for management to reassess or revise its [previous years'] conclusion[s] related to the effectiveness of ICFR, management should consider whether its original disclosures are still appropriate." In addition, the proposed guidance points to similar considerations with respect to assertions regarding the effectiveness of disclosure controls and procedures in prior year executive certifications issued in accordance with Section 302.

In certain circumstances, management may encounter difficulty in assessing certain aspects of its ICFR, e.g., for outsourced processes where management is unable to obtain the requisite SAS 70 letter from the service organization and management is unable to assess the underlying controls and sufficient compensating controls are not in place. As management is not permitted to issue a report with a scope limitation, a determination must be made whether the inability to assess controls over a particular process is significant enough to conclude that ICFR is not effective.

## Documentation

The proposed interpretive guidance explains the nature and extent of evidential matter that management must maintain in support of its assessment including how management has flexibility in approaches to documentation. The basic premise of the guidance is that management's assessment must be supported by evidential matter. That evidential matter must provide reasonable support for management's assessment of ICFR. That all said, the SEC indicates "we would expect reasonable support for an assessment to include the basis for management's assessment, including documentation of the methods and procedures it utilizes to gather and evaluate evidence." Documentation of the design of key controls is an integral part of that support.

The Commission's proposed guidance provides the following example:

[M]anagement may document its overall strategy in a comprehensive memorandum that establishes the evaluation approach, the evaluation procedures, and the basis for conclusions for each financial reporting element. Management may determine that it is not necessary to separately maintain copies of the evidence it evaluates; however, the evidential matter within the company's books and records should be sufficient to provide reasonable support for its assessment.

The nature of the evidential matter may vary based on the assessed level of risk and other circumstances. However, the SEC's comments above suggest there are some minimum expectations as to what constitutes "reasonable support." The proposed guidance provides that the evidential matter provide the basis for management's conclusions about the controls related to individual financial reporting elements.

Points made by the proposed guidance regarding documentation include the following:

- Recognize that the form and extent of documentation will vary depending on the size, nature, and complexity of the company – For example, the SEC points out that in smaller companies, management's daily interaction with its controls may provide the basis for its assessment in specific areas. In such instances, "management may have limited documentation created specifically for the evaluation of ICFR." Management should consider whether reasonable support for its assessment in these instances would include "documentation of how its interaction provided it with sufficient evidence", such as memoranda, e-mails, and instructions and other correspondence from management to company employees. In addition, the evidential matter will vary depending on the assessed level of risk. To determine the evidence needed to support the assessment for a given financial reporting element, the SEC is of the view that management should consider both the materiality of the financial reporting element and its susceptibility to material misstatement.
- Recognize that documentation can take many forms – Documentation may consist of paper documents, electronic, or other media and it can be presented in a number of ways (e.g., policy manuals, process models, flowcharts, job descriptions, documents, internal memorandums, forms, etc).
- Document only the controls that matter – The documentation supporting management's assessment does not need to include the entire population of controls that exists within a process that impacts financial reporting. The documentation should be focused on those controls that management concludes are adequate to address the identified financial reporting risks.
- Accomplish other important internal control-related objectives through documenting controls design – In addition to providing support for the assessment of ICFR, the proposed guidance asserts that documentation of the design of controls:
  - "[S]erves as evidence that controls within ICFR, including changes to those controls, have been identified, are capable of being communicated to those responsible for their performance, and are capable of being monitored by the company."

- “[P]rovides the foundation for appropriate communication concerning responsibilities for performing controls and for the company’s evaluation and monitoring of the operation of controls.”
- Provides “evidential matter, including documentation, of the entity-wide and other pervasive elements of [the company’s] ICFR that [management] believes address the elements of internal control that its chosen control framework prescribes as necessary for an effective system of internal control.”
- Consider the entity-level controls in place when evaluating the extent of evidence needed – The existence of entity-level controls may influence management’s determination of the evidence needed to sufficiently support its assessment. For example, if management determines that there is a strong control environment, management may consider this conclusion when determining the evidence needed to evaluate whether a particular control is operating effectively. If management believes that an entity-wide control addresses a specific financial reporting risk, then the reasonable evidential matter would ordinarily include documentation of how management reached that conclusion.
- Recognize that reliance on management’s daily interaction impacts the level of documentation available – The proposed guidance indicates that in those situations in which management is able to rely on its daily interaction with its control processes as the basis for its assessment, “management may have limited documentation created specifically for the evaluation of ICFR” in addition to “documentation regarding how its interaction provided it with sufficient evidence.”

## Special Considerations for Foreign Private Issuers

The proposed guidance addresses the point of focus when assessing risk for foreign private issuers filing financial statements in accordance with the local country accepted accounting principles or with International Financial Reporting Standards (IFRS) with an accompanying reconciliation to U.S. GAAP. These issuers should plan and conduct their evaluation process based on their primary financial statements. In other words, they should focus their evaluation on their local country or IFRS financial statements rather than the reconciliation to U.S. GAAP. However, because the reconciliation to U.S. GAAP is important to investors, the proposed guidance also states that management should consider the impact of control deficiencies on the U.S. GAAP reconciliation disclosure. Thus management of foreign private issuers evaluates the severity of a control deficiency in terms of both the primary financial statements and the amounts reported in the reconciliation to U.S. GAAP.

## Overall Implications of the Proposed Interpretive Guidance

There are several points to keep in mind when reviewing the SEC’s proposed guidance. First, the SEC indicates that, in developing the guidance, it assumed that management has already established and maintains a system of internal accounting controls in accordance with the Foreign Corrupt Practices Act of 1977 (FCPA). Second, the guidance does not explain how management should design its ICFR to comply with the control framework it has chosen; it only explains the process whereby management evaluates the controls in place using the selected control framework. Third, the guidance is not a cookbook and does not provide a checklist of steps for

management to complete. A reading of the guidance indicates that the SEC was very careful to avoid being prescriptive, so that U.S. accelerated filers that have been around the compliance track at least twice wouldn't have to go back to the drawing board and redo their evaluation process – provided they are satisfied with their current process going forward.

The proposed interpretive guidance encourages management to apply judgment based on the unique facts and circumstances. If released in its current form, the proposed guidance is likely to have a number of impacts in practice. Following are six that come to mind:

- (1) It will redirect the management-auditor dialogue – Management will have its own authoritative guidance to draw from and will no longer need to look to the auditor for significant help in this area. The void that has existed since Section 404 compliance began will be largely filled with a baseline guidance release that can be refined over time as companies and the SEC gain more experience with the ICFR evaluation process.
- (2) It will increase the focus on risk throughout the evaluation process – This sharper risk focus will lead companies to refine their rationalization of risk and controls. This effort will lead to more cost-effective test plans and more streamlined documentation that allocate more effort to higher risk areas and less effort to lower risk areas. In addition, multi-location scoping will become more risk-based, rather than an exercise in achieving coverage through arbitrary rules.
- (3) It will sharpen the focus on anti-fraud programs – The controls to prevent, deter and detect fraud will receive increased emphasis. In addition, attention will increase on controls around the risk of management override of established controls and the contribution of the audit committee's oversight role in reducing the risk of management override. The SEC and PCAOB both appear to be committed to increasing the focus of Section 404 compliance on the important things that really matter.
- (4) It will drive companies to focus on implementing a top-down approach to selecting the most important controls – Examples of the implementation of a top-down approach will make the concept more robust, particularly in terms of relying on monitoring controls and self-assessment (see (5) below). Long-term, companies will improve their upstream business processes and systems to improve their monitoring and automated testing capabilities. In addition, the guidance will help sharpen the emphasis in the year-to-year maintenance process.
- (5) It will increase the application of self-assessment in practice – Self-assessment is a versatile technique and the SEC's proposed guidance exploits it fully as a tool for increasing transparency in how controls are performing.
- (6) It will facilitate simpler planning and year-end assessment processes – By revising the definitions of a "significant deficiency" and a "material weakness" and clarifying the role of materiality, including the use of interim period materiality, the guidance should help clarify and focus the front-end planning process and redirect the year-end assessment process. The PCAOB is making similar changes in the auditing standard for auditors.

As companies begin to focus their approach more on a top-down, risk-based approach, a learning curve will occur as they transition away from the auditor standard-directed dialogues of the past. The proposed guidance provides management flexibility in determining how much documentation is

required to support the evaluation. Simply stated, the proposed guidance is based on the premise that an insider's approach to evaluating ICFR is different from an external auditor's approach due to management's day-to-day involvement in running the company. Through its ongoing supervision of and frequent interaction with process and control owners, management has available a body of evidence around the effectiveness of ICFR that the auditor does not have. To help drive this new reality home, the SEC:

- 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. This amendment would state that, although there are many different ways to conduct an evaluation of the effectiveness of ICFR to meet the requirement in the rule, an evaluation conducted in accordance with the interpretive guidance issued by the Commission would satisfy the annual management evaluation requirement.
- Proposed to revise Rule 2-02(f) to require the auditor to express only an opinion directly on the effectiveness of ICFR, eliminating the auditor's opinion on management's assessment of ICFR in the auditor's attestation report.

These rule amendments would make it clear that the authoritative literature for management's evaluation lies with the SEC's interpretive guidance, and not with the literature written for auditors. Furthermore, the elimination of the auditor's opinion on management's assessment of ICFR in the auditor's attestation report should significantly lessen, if not eliminate, the pressures that managers have felt to look to the auditing standards for guidance in performing their evaluations. Now that management is allowed to have a different testing approach from the auditor, the days of management being compelled to do what the auditor would do are over. Everything that management does should be directed solely by risk.

As smaller public companies often have less complex internal control systems than larger public companies, this proposed guidance encourages smaller public companies to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances. We can expect the SEC to issue further guidance in the future to address the scalability of Section 404 compliance.